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## The Anti-Competitive Music Industry and the Case for Compulsory Licensing in the Digital Distribution of Music

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## COPYRIGHT

# THE ANTI-COMPETITIVE MUSIC INDUSTRY AND THE CASE FOR COMPULSORY LICENSING IN THE DIGITAL DISTRIBUTION OF MUSIC

*Ankur Srivastava*\*

### ABSTRACT:

Because the music industry is an oligopoly in which several major firms exert their market power to suppress competition, a sub-optimal level of creative content is produced. This market inefficiency is remedied by digital file sharing networks, which significantly reduce distribution costs and allow artists unaffiliated with the major record labels to reach mass audiences. However, the use of file sharing networks to break down barriers constructed by the dominant firms is an imperfect solution because of widespread piracy and the illegality of some of these networks. Accordingly, the market for music can be bolstered by government intervention in the form of a compulsory licensing scheme administered by a regulatory agency. Under the terms of the licensing scheme, online vendors would be permitted to digitally distribute any commercially released song provided that they pay royalties to the artist within predetermined guidelines. This Article is divided into four parts: Part I explores the current structure of the music industry and its negative effects on creative output; Part II argues that illegal file sharing spurs innovation; Part III contends that the market cannot reproduce the

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positive effects of illegal file sharing; and Part IV proposes a system of compulsory licensing to promote innovation in the music industry while ensuring that artists are compensated for their labor.

## TABLE OF CONTENTS

INTRODUCTION .....	381
I. THE MUSIC INDUSTRY INHIBITS INNOVATION .....	384
A. The Market for Music Is Dominated by the Five Major Distributors.....	384
1. Who Are the “Big Five”? .....	385
2. A Concentrated Market .....	386
B. The Major Labels Use Prohibitively High Marketing Costs to “Crowd Out” Smaller Artists .....	388
1. Cooperative Advertising Programs and MAP Policies Are Marketing Policies That Stifle Competition.....	390
a. How the MAP Policies Worked .....	391
b. MAP Policies Were Successful in Artificially Inflating Prices .....	392
c. Cooperative Advertising Programs Allow the Major Labels to Monopolize Retailer Shelf Space .....	394
2. Major Distributors Use Their Market Power to Monopolize Radio and Deny Competitors Access to Listeners.....	395

2006]	<i>THE ANTI-COMPETITIVE MUSIC INDUSTRY</i>	377
C.	The Industry's Structure Allows the Major Labels to Enjoy Monopoly Power and Suggests That Current Copyright Protections Are Too Strong.....	399
1.	The Major Labels Collectively Function as a De Facto Monopoly .....	399
2.	The Existing Level of Copyright Is Too Strong and Discourages the Creation of More Creative Content.....	401
II.	PEER-TO-PEER FILE SHARING INCREASES INNOVATION .....	404
A.	How the Technology Works .....	405
1.	The Napster Model .....	407
2.	The Decentralized Server Model .....	407
B.	Empirical Evidence Shows That File Sharing Does Not Harm Record Sales.....	409
C.	File Sharing Benefits Small Artists and Increases Their Incentives to Innovate.....	415
1.	Small Artists Are Dissimilarly Situated From Large Artists.....	415
2.	Small Artists Unrepresented by a Major Label Benefit From Illegal File Sharing .....	416
3.	Artists Support the Notion That File Sharing Promotes Their Careers.....	417
4.	The Wilco Story.....	418

D. The Impact of File Sharing on Large Artists Is Unclear, but File Sharing Is Unlikely to Deter Them From Creative Innovation .....	419
1. Illegal File Sharing May Not Harm Artists Since Record Labels Recoup Most of the Profits From Album Sales .....	421
2. Illegal File Sharing Provides Artists With Free Marketing That Is Likely to Promote Concert Ticket Sales, Merchandising Opportunities, and Other Ancillary Benefits .....	424
E. File Sharing Networks Ultimately Encourage Innovation, but May Be Driven Out of Business .....	425
III. THE MARKET WILL NOT SUPPORT FILE SHARING TECHNOLOGY .....	428
A. The Major Labels Have No Incentive to Promote File Sharing Technology .....	430
1. The Online Distribution of Music Erodes the Profitability of Compact Disc Sales .....	430
2. The Suppression of Online Music Distribution Enables the Major Labels to Monopolize the Market for Music .....	431
B. Online MP3 Vendors Must Offer a Wide Library of Songs to Compete with Illegal File Sharing Networks...	432
C. Third-Party Vendors Are Unlikely to Assemble a Competitive Library of Songs, or, Alternatively, Are Unlikely to Be Profitable .....	436

2006]	<i>THE ANTI-COMPETITIVE MUSIC INDUSTRY</i>	379
1.	Third Party Vendors Will Not Have the Bargaining Power to Negotiate Favorable Terms with All Five Major Labels .....	436
2.	The False Promise of Collective Rights Organizing..	438
3.	Game Theory and Keeping Out Competitors .....	439
D.	Online Ventures Run by the Major Labels Themselves	
	Invoke Antitrust Concerns .....	441
IV.	THE ARGUMENT FOR COMPULSORY LICENSING.....	445
A.	Possible Solutions .....	446
1.	The Contenders .....	446
2.	The Compulsory Licensing Solution .....	447
B.	How Compulsory Licensing Would Work and the Benefits of Such a System.....	449
1.	The Formation of a Regulatory Agency .....	449
2.	The Independent Artist Requirement.....	450
3.	Flexible Pricing Increases the Likelihood That Artists Will Be Paid .....	451
4.	Non-Discriminatory Licensing .....	453
5.	Compulsory Licensing Will Save File Sharing and Other Forms of Legal Online Music Distribution.....	453
6.	Summary .....	453
C.	Compulsory Licensing Is an Appropriate Response to Current Market Conditions.....	455
1.	The Music Industry Is the Type of Market for Which Regulation Is Appropriate .....	455

2. Compulsory Licensing in the Music Industry:	
Other Contexts .....	456
3. The Music Online Competition Act.....	458
D. Challenges to Compulsory Licensing and Responses....	460
1. Institutional Incompetence and Why It Does Not	
Matter.....	460
a. Problems in Price-Setting and Price-Adjusting ....	460
b. The Current Market Structure Already Distorts	
Prices.....	461
c. Price Ranges Address Merges' Concerns About	
Inflexible Pricing .....	462
2. The Problem of Regulatory Capture .....	463
3. The Problem of Illegal File Sharing.....	465
CONCLUSION.....	466
APPENDIX I: Index of Five Major Labels .....	469
APPENDIX II: CD Sales: Where the Money Goes.....	472

## THE ANTI-COMPETITIVE MUSIC INDUSTRY AND THE CASE FOR COMPULSORY LICENSING IN THE DIGITAL DISTRIBUTION OF MUSIC

### INTRODUCTION

One of the most startling byproducts of the Internet revolution has been the widespread and illicit sharing of copyrighted musical works. The Recording Industry Association of America (“RIAA”) reported that an astonishing two billion songs are traded online each month.<sup>1</sup> Clearly, this development has enormous ramifications for numerous stakeholders, running the gamut from artists to record labels to consumers. This Article argues that there should be government regulation in the online distribution of copyrighted musical works. More specifically, it argues for a scheme of compulsory licensing in which a federal agency would set different regulatory rules such as mandated price ranges for the online distribution of songs. A system of compulsory licensing already exists in other contexts within the music industry,<sup>2</sup> and some scholars have proposed statutory compulsory licensing as a possible solution to the high transaction costs involved in contracting with a large

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<sup>1</sup> Hillary M. Kowalski, *Peer-To-Peer File Sharing & Technological Sabotage Tactics: No Legislation Required*, 8 MARQ. INTELL. PROP. L. REV. 297, n.95 (2004).

<sup>2</sup> WILLIAM W. FISHER III, *PROMISES TO KEEP: TECHNOLOGY, LAW, & THE FUTURE OF ENTERTAINMENT* 41, 48, 105-08, 145 (Stanford University Press) (2004). For example, public broadcasting organizations, the operator of a jukebox, composers of a song, public commercial broadcasts and Webcasters are all permitted to play a certain song so long as



number of different music publishers.<sup>3</sup> This Article intends to contribute to the literature in the following ways: first, by arguing that the anti-competitive nature of the music industry inhibits innovation and that this anti-competitive structure is what justifies government regulation in the form of compulsory licensing, and second, by detailing how a scheme of compulsory licensing could be effectively implemented and how such a system's benefits would outweigh its costs.

This Article advances five basic arguments: 1) the government should grant copyrights to innovators in order to generate the optimum level of creative output; 2) the copyright system fails to generate the optimum level of output in the music industry because the industry is anticompetitive and a sub-optimal level of music is ultimately distributed to the public; 3) file sharing is a technological breakthrough collapsing bottlenecks in the marketplace and spurring the innovation of creative works; 4) industry pressure and the existing legal regime are suppressing online distribution networks, leading to a less than optimum level of music available to the public; and 5) the sub-optimal level of creative production justifies the government's intervention to encourage more creative expression by enacting a scheme of compulsory licensing.

Part I of this Article will outline the myriad ways in which the current market structure of the music industry inhibits innovation. It

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they pay a modest administratively determined fee. *Id.*

<sup>3</sup> See, e.g., Matthew Fagin, Frank Pasquale & Kim Weatherall, *Beyond Napster: Using Antitrust Law to Advance and Enhance Online Music Distribution*, 8 B.U. J. SCI. & TECH. L. 451, 523-27 (2002).

2006] *THE ANTI-COMPETITIVE MUSIC INDUSTRY* 383

argues that the industry is controlled by five record label conglomerates who employ anticompetitive practices to crowd smaller, less established artists out of the standard distribution channels (such as radio or television) needed to successfully reach listeners and consumers. Accordingly, the current market structure works to hinder innovation.

Part II discusses how peer-to-peer file sharing networks, contrary to conventional wisdom, actually increase innovation by eroding copyright protections, at least in the short run. These file sharing networks do so by lowering distribution costs so that struggling or poorer artists can more cheaply disseminate their music to larger audiences. These incentives to innovate outweigh any potential disincentives encountered by musicians whose files are illegally traded.

Part III argues that the marketplace needs to develop an alternative to peer-to-peer file sharing networks in order to protect the rights of artists. Currently, most alternative networks cannot compete with illicit networks because of current market conditions and the enormous number of parties involved. Moreover, even if the market did develop alternative networks of online music distribution, with prices low enough to compete with the illegal networks, the highly concentrated nature of the industry would lead to major antitrust issues.

Part IV therefore argues that the government is justified in intervening in the market and outlines several possible solutions, including a legal exemption for non-commercial file sharing, the

breaking up of the five major distribution labels, and national sponsorship of all artists funded through taxation. This Article ultimately settles on a system of compulsory licensing, which would convert property rules in music to liability rules in the context of online distribution. This scheme would enable any vendor to sell any artist's music online on the same terms offered to every other online vendor and within a predetermined price range set by the government.

## **I. THE MUSIC INDUSTRY INHIBITS INNOVATION**

### **A. The Market for Music Is Dominated by the Five Major Distributors**

At first glance, the music industry appears to be consistent with the economic model of a smoothly functioning competitive market. It involves an enormous number of consumers purchasing music from a vast number of disparate producers. Yet, the market functions more as an oligopoly<sup>4</sup> in which the creative works of all artists are funneled through a limited number of record labels that each exert control over prices and their competitors' behavior. These major labels are unique in that they not only possess the vast resources needed to successfully promote and develop artists, but they also control access to television, radio and other distribution channels which artists utilize to reach consumers. Hence, the major labels possess tremendous influence over the artistic content to which

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<sup>4</sup> BLACK'S LAW DICTIONARY 1120 (7th ed. 2004) defines "oligopoly" as "[c]ontrol or domination of a market by a few large sellers, creating high prices and low output similar to

the public has access. This section of the Article argues that the five major record labels wield a disproportionate amount of market power, which enables them to suppress the dissemination of music created by independent artists or those working with less prominent record labels. Hence, the current market structure results in a situation in which less than the optimal amount of music is being produced.

### 1.      *Who Are the “Big Five”?*

The “big five” record labels, including their various subsidiaries, own and control nearly all of the music owned by American consumers or available to consumers over public airwaves in the United States.<sup>5</sup> The five record labels are Vivendi’s Universal Music Group, Sony Music Entertainment, EMI Recorded Music, Warner Music Group and BMG Entertainment.<sup>6</sup> Appendix I includes a list of the “big five” labels, their subsidiaries, and some of the major artists represented by each label. These five labels control 85% of the recorded music market in the United States.<sup>7</sup> Moreover, the remaining 15% of recorded music, controlled by independent labels, is often distributed through the five major labels.<sup>8</sup>

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those found in a monopoly.”

<sup>5</sup> Anthony Maul, *Are the Major Labels Sandbagging Online Music? An Antitrust Analysis of Strategic Licensing Practices*, 7 N.Y.U. J. LEGIS. & PUB. POL’Y 365, 368 (2004).

<sup>6</sup> *Id.* at 366 n.8. Additionally, an outline of the various subsidiary labels owned by each of these five mega-labels as well as a representative sampling of some of the major artists carried by each label is included in Appendix I.

<sup>7</sup> Fagin, *supra* note 3, at 467 (citing figures provided by the Federal Trade Commission, e.g., Complaint, In re Sony Music Entertainment, Inc., No. C-3971, Aug. 30, 2000, available at <http://www.ftc.gov/os/2000/09/sonycomp.htm> (last visited Mar. 9, 2006)).

<sup>8</sup> Peter Jan Honigsberg, *The Evolution and Revolution of Napster*, 36 U.S.F. L. REV. 473, 477 (2002) (recognizing that “[t]he five companies and their major labels compose eighty-

2. *A Concentrated Market*

Is the music industry a competitive market? One way to empirically measure the competitiveness of a market is through application of the Herfindahl-Hirschman Index (HHI)<sup>9</sup> Antitrust economists use the index to measure competitiveness by determining the extent to which output is produced by a few select firms.<sup>10</sup> The index is calculated by taking the market share of each firm in the industry, squaring each figure, and taking the sum.<sup>11</sup> A score of one hundred would imply one hundred equal-sized firms with equal output, because each firm would possess a market share of one; squared and added up, the one hundred firms add up to an HHI score of 100, which is akin to a perfectly competitive market. Conversely, if one firm controls the entire market,  $100^2 = 10,000$  which is the highest HHI score possible and describes a monopoly market. The higher the HHI score, the more concentrated the market power of the firms.<sup>12</sup> The Department of Justice uses the following enforcement guidelines: a HHI of under 1000 is an unconcentrated market, a HHI of greater than 1000 is a moderately concentrated market, and a HHI of greater than 1800 is a highly concentrated market.<sup>13</sup>

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five percent of the recording industry. The other fifteen percent is made up of independent labels, most of which use the majors to distribute their music.”).

<sup>9</sup> Economist.com, Research Tools: Economics A–Z, <http://economist.com/research/Economics/alphabetic.cfm> (follow “Herfindahl-Hirschman index” hyperlink) (last visited Mar. 9, 2006).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> See U.S. Department of Justice and Federal Trade Commission, 1992 Horizontal Merger Guidelines (1992), <http://www.ftc.gov/bc/docs/horizmer.htm> (last visited Mar. 9, 2006). “The Agency divides the spectrum of market concentration as measured by the HHI into three regions that can be broadly characterized as unconcentrated (HHI below 1000),

Unfortunately, an exact HHI measurement is impossible because data regarding the market share possessed by each of the five major labels is unavailable. However, the limited information available is enough to gauge whether the music market is highly concentrated or not. Assuming that the five firms each own an exactly equal portion of their combined market share of 85%, the HHI score for the music industry would be 1445.<sup>14</sup> This would make the industry fall somewhere between the guideline ranges set for moderately and highly concentrated markets.<sup>15</sup> However, note that the HHI score is undoubtedly higher than 1445 for two reasons. First, this calculation does not take into account the 15% of the market owned by other firms, which should be added into the industry's HHI score. Second, any variation from the assumption that the five major labels each own an equal share of the market will drive up the HHI score. Even a minor variance in a given firm's market share can noticeably drive up the HHI score. Postulate, for example, that three of the labels each control 17% of the market, while the remaining two control 9% and 25% respectively. In effect, we have only shifted 8% of the market from one of the five major labels to another of the five major labels and held constant the assumption that the other three labels each share an equal portion of the market. Under these market conditions, the HHI score increases to 1573,<sup>16</sup> much closer to the Department of

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moderately concentrated (HHI between 1000 and 1800), and highly concentrated (HHI above 1800)." *Id.*

<sup>14</sup>  $17^2 + 17^2 + 17^2 + 17^2 + 17^2 = 1445$ .

<sup>15</sup> See *supra* note 13.

<sup>16</sup>  $17^2 + 17^2 + 17^2 + 9^2 + 25^2 = 1573$ .

Justice's range for a highly concentrated market.<sup>17</sup> Standing alone, the highly concentrated market structure of the music industry does not make for a compelling case that the music industry functions in an anticompetitive manner. However, the HHI score standing alone is sufficient to cast a shadow of suspicion on the competitiveness of the market. Moreover, in conjunction with several other anticompetitive characteristics of the music industry, it is clear that the five major labels do exert their market power to suppress competition.

**B. The Major Labels Use Prohibitively High Marketing Costs to "Crowd Out" Smaller Artists<sup>18</sup>**

The primary way in which the major distributors suppress their competition is by creating market structures that prohibitively increase the costs of entering the market.<sup>19</sup> In classic economic terms, the constituents of an oligopoly exert their considerable economic power to create barriers to entry. Mark Nadel has described the current entertainment industry as one in which sub-industries such as the one for music can be characterized as "lottery-like, 'winner-take-all' markets, where promotional efforts may be more important than content."<sup>20</sup> Under Nadel's view of the market, success is determined not only by the quality of artistic content, but

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<sup>17</sup> See *supra* note 13.

<sup>18</sup> Much of this section borrows from the pioneering work of Mark S. Nadel, *How Current Copyright Law Discourages Creative Output: The Overlooked Impact of Marketing*, 19 BERKELEY TECH. L.J. 785 (2004) (arguing that current copyright law suppresses innovation in the entertainment industry).

<sup>19</sup> *Id.* at 801.

<sup>20</sup> *Id.* at 790.

perhaps even more so by the quality and quantity of a music label's promotional efforts.<sup>21</sup> Nadel describes how "major music labels spend hundreds of thousands [of dollars], on average, on promotion for a new album (including payola<sup>22</sup>), as compared to only \$80,000 to \$150,000 for producing them. Michael Jackson even complained when Sony spent *only* about \$25 million to market his album 'Invincible.' "<sup>23</sup>

Not only are promotional expenditures conducive to success in today's market, they are virtually required. A particular musician might be the most gifted songwriter alive, but without the ability to impress a talent scout working for one of the five major distributors, the reality is that very few consumers will ever be exposed to that artist's songs. The labels not only spend money to promote their own artists, but do so out of necessity and the fear of being crowded out themselves. As Nadel notes:

The marketing expenditures of competitors also become a major factor in determining which projects will be profitable, creating a promotional 'arms race.' As one commentator observed, 'the costs of marketing new releases to a mass audience have grown prohibitive . . . [and] those costs have long helped limit competition from smaller companies.' As a result, high quality content, especially from smaller producers without deep pockets, can be drowned

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<sup>21</sup> *Id.* at 799-800.

<sup>22</sup> Douglas Abell, *Pay-For-Play: An Old Tactic in a New Environment*, 2 VAND. J. ENT. L. & PRAC. 52, 53-54 (2000). Abell defines "payola" as the "music industry practice of paying money to people in exchange for promoting a particular piece of music . . . [including] payments of any type made in exchange for broadcast of material." *Id.* at 53; *see infra* Part I.B.2.

<sup>23</sup> Nadel, *supra* note 18, at 790.



out.<sup>24</sup>

Therefore, under current market conditions, marketing has taken on an increasingly important role. Only those artists financially supported by the one of the five major labels can afford to successfully market their albums to the consuming public. Two industry practices in particular underscore the extent to which the major distributors exercise their market power to stifle competition: 1) cooperative advertising and minimum advertised pricing (“MAP”) policies, and 2) pay-for-play promotion schemes.

*1. Cooperative Advertising Programs and MAP Policies Are Marketing Policies That Stifle Competition*

One example of the way in which the major distributors have exerted their market power to suppress competition is in their use of MAP policies. These policies invoke considerable skepticism as to whether the market for music operates competitively, particularly in light of the fact that the five major labels utilized MAP policies to artificially raise prices only a few years ago.<sup>25</sup> The Federal Trade Commission (“FTC”) conducted an inquiry into music industry practices, and, in 2000, “unanimously found reason to believe that the arrangements entered into by the five largest distributors of prerecorded music violate the antitrust laws.”<sup>26</sup>

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<sup>24</sup> *Id.* at 801.

<sup>25</sup> Chairman Robert Pitofsky et al., *Federal Trade Commission: Market for Prerecorded Music*, <http://www.ftc.gov/os/2000/09/musicstatement.htm> (last visited Mar. 9, 2006).

<sup>26</sup> *Id.*

## a.      How the MAP Policies Worked

Each of the five major labels operate “cooperative advertising programs,” which at one time included MAP policies.<sup>27</sup> Under the cooperative advertising programs, the five major labels give retailers advertising funds to market the compact discs being distributed by the labels. However, under the MAP policies, the labels attached conditions to the receipt of these funds, such as the requirement that retailers advertise a certain minimum price.<sup>28</sup> While these cooperative advertising programs did not require retailers to *charge* a certain price, the fact that participating retailers were required to advertise a minimum price operated to artificially inflate the prices of compact discs and increase the profit margins of the major distributors.

The MAP policies operated to raise prices in the manner described below. The prices given are all approximations, but assume that the retail price of a compact disc is \$17.99, and that retailers purchase the disc at a wholesale price of \$10.99. Absent MAP conditions, retailers would normally be expected to compete away much of the \$7 profit margin and settle on a price of say, \$12.99 for a compact disc. However, because retailers were subject to the minimum advertised price policies there was no way for them to signal to consumers that they were selling the compact discs at a price below retail. Accordingly, because of an inability to communicate with consumers, retailers had no incentive to lower

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<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

their prices and the net result was that they sold their compact discs at or close to the retail price of \$17.99. Given the huge profit margin being made by retailers, distributors were able to raise their wholesale prices beyond \$10.99 to increase their own profit margin. It can be argued that for some products the type of “retail price maintenance” in which the labels were engaged is not anticompetitive because it leads retailers to employ knowledgeable sales clerks, distribute better warranties, or provide other types of services that enhance the quality of the product being sold. However, it is the view of this Article that the setting of minimum advertised prices by the music industry did not lead to a corresponding increase in the quality of compact discs being offered; rather, the effect of such policies was strictly anticompetitive. As the following section will show, this view was shared by the FTC.

b. MAP Policies Were Successful in  
Artificially Inflating Prices

These MAP policies, described abstractly in the preceding section, worked in practice as well. As the FTC concluded,

[t]he MAP policies were adopted by each of the distributors for the purpose of stabilizing retail prices . . . [They] achieved their purpose and effectively stabilized retail prices with consequential effects on wholesale prices, ending the price competition that previously existed in the retail marketplace and the resulting pressure on the distributors’ margins.<sup>29</sup>

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<sup>29</sup> *Id.*

2006] *THE ANTI-COMPETITIVE MUSIC INDUSTRY* 393

The MAP policies the industry implemented in 1995 and 1996 were stronger than the MAP policies it had previously employed. They were stronger because they mandated minimum price advertising even in advertising paid for entirely by the retailer.<sup>30</sup> The net effect was higher consumer prices. The FTC ultimately settled with each of the five major labels, releasing a press statement that “[t]he proposed agreements would settle FTC charges that all five companies illegally modified their existing cooperative advertising programs to induce retailers into charging consumers higher prices for CDs, allowing the distributors to raise their own prices.”<sup>31</sup> FTC Chairman Robert Pitofsky noted that

[t]he FTC estimate[d] that U.S. consumers may have paid as much as \$480 million more than they should have for CDs and other music because of these policies over the last three years. These settlements will eliminate these policies and should help restore much-needed competition to the retail music market.<sup>32</sup>

Ultimately, any consumer who had purchased a compact disc or pre-recorded music product between 1995 and 2000 was entitled to a cash payout.<sup>33</sup> Under their settlement agreements, the five labels were collectively forced to make cash payments of \$67,375,000 and to donate \$75,700,000 worth of prerecorded compact discs.<sup>34</sup>

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<sup>30</sup> See *supra* note 25.

<sup>31</sup> Federal Trade Commission, Record Companies Settle FTC Charges of Restraining Competition in CD Music Market: All Five Major Distributors Agree to Abandon Advertising Pricing Policies (May 10, 2000), <http://www.ftc.gov/opa/2000/05/cdpres.htm> (last visited Mar. 9, 2006).

<sup>32</sup> *Id.*

<sup>33</sup> MusicSettlement.com, In re: Compact Disc Minimum Advertised Price Antitrust Litigation Settlement, available at <http://www.musiccdsettlement.com/english/default.htm> (last visited Mar. 9, 2006).

<sup>34</sup> *Id.*

Clearly, the five major labels have a recent history of acting in concert to suppress competition and increase their profits.

c. Cooperative Advertising Programs  
Allow the Major Labels to Monopolize  
Retailer Shelf Space

While the price-fixing effect of the MAP policies are what drew the wrath of the FTC and have inspired commentary in the relevant literature, there is another aspect of the cooperative advertising programs that is equally disturbing: these policies work to suppress the distribution of new music.<sup>35</sup> The cooperative advertising programs – which are still in effect today – operate to ensure that retailers will reserve shelf space for artists carried by one of the five major labels.<sup>36</sup> Given their own limited advertising budgets, retailers gladly accept payments from the major distributors to promote their music.<sup>37</sup> This system crowds out opportunities for independent artists to reach consumers because retailers do not publicize the work of independent artists in newspaper

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<sup>35</sup> H. Damian Elahi, *Record Distributors' Minimum Advertised Price Provisions: Tripping Antitrust During Pursuit of Revenue, Control, and Survival in the Openly Competitive Digital Era*, 21 LOY. L.A. ENT. L. REV. 437, 447-49 (2001) (recognizing that "MAPs can be analyzed as both horizontal and vertical restraints of trade under section 1 of the Sherman Act.").

<sup>36</sup> *Id.* at 447-49. The MAP provisions evolved in response to retailers' complaints that they were being undercut by the large discount chain stores. *Id.* at 447. To curb this destabilizing effect, distributors responded by threatening to cease advertising funds if minimum advertised pricing was not complied with by discount chains and retailers. *Id.* at 449. Soon, MAP provisions were enforced by all the five distributors which secured their product on the retail and discount chain shelves. *Id.* at 448-49.

<sup>37</sup> Howard M. Morse, *Cooperative Advertising Programs & Minimum Advertised Price Policies: Changing the Antitrust Rules*, 1, <http://www.abanet.org/antitrust/committees/counsel/coop.pdf> (last visited Mar. 9, 2006) (stating that MAP programs reimburse dealers "for the cost of advertising so long as the advertised price is not below a specified minimum").

advertisements or any other media. Moreover, work created by independent artists is unlikely to receive shelf space because the independent labels do not have funds to make similar cooperative advertising agreements. While there is no empirical evidence to support this claim because this aspect of the labels' advertising programs has escaped inquiry in the relevant literature, common sense indicates that retailers will primarily allocate shelf space only to those artists carried by large labels in order to collect advertising funding. If shelf space at retail stores is akin to radio airplay in terms of reaching consumers, cooperative advertising programs limit the potential of smaller artists who do not have the advertising budgets necessary to compete with the advertising programs offered by the major labels. In short, because the major distributors pay retailers to promote their own artists, they minimize opportunities for artists who are unrepresented or carried by small labels to reach consumers. This in turn reduces incentives for these less-established artists to create new music. The cooperative advertising programs promulgated by the major distributors therefore function to stifle competition and crowd out smaller artists.

2.     *Major Distributors Use Their Market Power to  
Monopolize Radio and Deny Competitors  
Access to Listeners*

Another feature of the music industry which limits competition is the "pay-for-play" system. Under "pay-for-play," the five major labels indirectly pay for their music to be broadcast on

public radio airwaves.<sup>38</sup> While pay-for-play, or “payola,”<sup>39</sup> is technically illegal, the major distributors have found a loophole in FCC regulations that allow them to engage in this practice and suppress competition.<sup>40</sup> The distributors have evaded the prohibition against directly paying stations to play specific songs by creating a system in which the major labels hire independent record promoters who act as intermediaries between the labels and radio stations.<sup>41</sup> The independent promoters pay radio stations for the right to exclusively represent the station.<sup>42</sup> The promoter then promotes certain songs and encourages the stations to add those songs to its playlists.<sup>43</sup> For each song added to a radio station’s playlist, the promoter charges the record labels a promotion fee.<sup>44</sup>

The independent promoters generally pay the radio stations \$100,000 to \$400,000 per station, depending on market size.<sup>45</sup> The independent promoters then charge the distributors roughly \$800 per song added to a playlist in middle-sized markets and up to \$5,000 per song for large stations in large radio markets.<sup>46</sup> Most radio stations add roughly 150 to 200 songs to their playlists each year. The result

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<sup>38</sup> Eric Boehlert, *Will Congress Tackle Pay-For-Play?*, June 25, 2002, [http://www.salon.com/ent/feature/2002/06/25/pfp\\_congress/](http://www.salon.com/ent/feature/2002/06/25/pfp_congress/) (last visited Mar. 9, 2006).

<sup>39</sup> Readers interested in a more detailed description of “pay-for-play” or “payola” schemes may want to refer to the following illuminating article: James Surowiecki, *Paying to Play*, THE NEW YORKER, July 12, 2004, available at [http://www.newyorker.com/printables/talk/040712ta\\_talk\\_surowiecki](http://www.newyorker.com/printables/talk/040712ta_talk_surowiecki) (last visited Mar. 9, 2006); see also Boehlert, *supra* note 38.

<sup>40</sup> Boehlert, *supra* note 38.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> Boehlert, *supra* note 38.

<sup>46</sup> *Id.*

2006] *THE ANTI-COMPETITIVE MUSIC INDUSTRY* 397

of this, according to one commentator, is that “very little of what we hear on today’s radio stations isn’t bought, one way or another.”<sup>47</sup>

One radio station programmer has described the system as follows:

Record companies say, ‘We’re not doing anything illegal; we’re just paying indies to promote the records’ [while] indies say ‘we’re not doing anything wrong; we’re just helping market a radio station.’ Everybody toes the company line on this. But indies are like money launderers; they make sure record company money gets to radio stations, but in a different form.<sup>48</sup>

Exactly how much record company money gets to radio stations? One estimate is that a record company spends “about \$250,000 just to launch a single on rock radio today. That doesn’t guarantee success; it just gives the single access to the airwaves. If the song catches on and eventually crosses over to the mainstream Top-40 format, [independent promoter] costs balloon to more than \$1million per song.”<sup>49</sup>

At first blush it may appear that this pay-for-play system harms distributors, who must pay to have their songs disseminated to the public. However, given the exorbitant costs associated with promoting a new song in this system, only the major distributors have the money needed to pay for a new song to be marketed. While a radio station is free to play any music it pleases, it stands to profit most by playing those songs marketed by the major distributors. After all, if a radio station plays those songs being pushed by the

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<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*



independent promoter with whom it has signed an exclusive contract, it generates profits for that independent promoter. The next time the radio station signs an exclusive representation contract, the independent promoter and any competitors will undoubtedly bid more money for the right to represent the station. The incentives clearly function to promote music being supported by independent promoters, who in turn endorse those songs being marketed by one of the five major labels.

Because most consumers learn about new music through their local radio stations, these stations wield enormous power in determining what artists gain access to the public. Further, by controlling what songs are played by radio stations, the major labels are able to ensure that only their music is disseminated to the public. In response, Senator Russell Feingold has introduced the "Competition in Radio and Concert Industries Act."<sup>50</sup> This legislation is designed to "[h]elp small and independent radio owners and promoters by curbing concentration to level the playing field in the marketplace" and to "[h]elp consumers by curbing concentration to promote diversity of information . . . ."<sup>51</sup> Two of the ways in which this legislation seeks to accomplish this goal are by closing the FCC loophole which allows independent promoters to act as intermediaries, and by requiring that any station being paid to play a particular song make an appropriate sponsorship identification

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<sup>50</sup> Senator Russell Feingold, *Feingold Introduces "Competition in Radio and Concert Industries Act"* (Jan. 28, 2003), available at <http://feingold.senate.gov/~feingold/releases/03/01/2003128910.html> (last visited Mar. 9, 2006).

<sup>51</sup> *Id.*

announcement.<sup>52</sup> However, unless this legislation passes the fact remains that the major label distributors wield an inordinate amount of influence and are able to leverage their market dominance to crowd out smaller, independent artists. Thus, the system of hiring independent promoters is yet another way in which the current market structure stifles innovation by constructively excluding new entrants.

**C. The Industry's Structure Allows the Major Labels to Enjoy Monopoly Power and Suggests That Current Copyright Protections Are Too Strong**

*1. The Major Labels Collectively Function as a De Facto Monopoly*

The net effect of the current market structure is that innovation is stunted because the market is unreceptive to artists who are not represented by one of the five major labels. It is unclear whether this effect is a product of market manipulation by the five major distributors or whether this is the natural equilibrium at which the market has settled given historical constraints.

For example, one might consider the current market structure to embody collusive behavior on the part of the major distributors. After all, each of the five major labels tends to set retail prices of its compact discs at the same level. While this in of itself is hardly

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<sup>52</sup> *Id.* Section 7 of the Act is entitled "Modification of regulations on announcement of payment for radio broadcast." *Id.* "This section closes a loophole in the FCC regulations covering 'payola' – pay-for-play – to ensure that radio station broadcasts are not improperly influenced by the payment, whether directly or indirectly, to the licensee of any radio station unless an appropriate sponsorship identification announcement is made." *Id.*

evidence of explicit collusive behavior, it may very well be evidence of tacit collusion on the part of the major labels.

Game theory can help to explain the cooperative behavior of the five major distributors in the music industry. Posit that each of the major distributors has equal market share as we did above, and that they share roughly equal costs for producing music of roughly equal consumer appeal (the assumption that they each possess equal market share can easily be relaxed without affecting the following analysis, so long as each of the five labels possesses enough market share to affect the market and the behavior of its four competitors). Further, assume that each of the labels can produce a compact disc of average consumer appeal at a cost of \$10, inclusive of all costs associated with talent development, production, packaging, promotion, etc. In considering the expected price, one might believe that the market for music is not perfectly competitive due to product differentiation. In other words, artistic creation is hardly fungible, and I might be willing to pay \$50 for the music of my favorite artist and \$0 for the music of an artist I do not care for. Nonetheless, the market does not tolerate this type of price differentiation, and in a competitive market, one might expect that the various sellers would whittle away their profit margin so that the competitive price settles at something only marginally higher than \$10 a disc. Regardless, the retail price of compact discs remains at roughly \$18.

What explains the inability of the market to shift some of the producer surplus into the hands of consumers? One explanation is that each of the five major labels possesses such control over the

market that their actions dictate the market price. Because they are repeat players, game theory dictates that they might settle on the profit-maximizing price and pool their collective market power to act as a monopoly. In other words, Firm A might be tempted to lower wholesale prices such that the retail price of its products is lowered to \$15. In order to compete, firms B, C, D, and E might very well follow suit until they compete away their profit margins. However, each firm can anticipate this sort of “tit-for-tat” behavior when they set their respective prices and the firms tacitly agree not to lower prices. This cooperative behavior is the optimum equilibrium for the five major labels because they each charge a monopoly price and extract maximum producer surplus from the market. Whether or not the firms are acting collusively is irrelevant from the perspective of crowding out competitive entrants to the market. Even absent explicit collusive agreements, the net result is that the oligopolists dominating the market are able to collectively act as a monopolist would: they maximize profits by suppressing supply and charging monopoly prices.

2. *The Existing Level of Copyright Is Too Strong and Discourages the Creation of More Creative Content*

The ultimate result of the way in which the market operates is that the major distributors are able to extract excess profits and have an incentive to suppress competition from independent artists and smaller record labels. This explains the mechanisms the major distributors have created to shut out competitors, such as minimum

advertised pricing and pay-for-play schemes. Moreover, if this analysis is correct, then current copyright protections might be viewed as *too* strong to produce the socially optimal amount of creative output. By providing too much copyright protection, copyright law, coupled with the existing market structure, works to heavily promote the artists who sign with a major distributor at the expense of all other musicians. In theory, the government's grant of copyright is supposed to encourage the optimal amount of innovation by making artistic endeavors more valuable and by making marginally profitable works commercially viable.<sup>53</sup> However, as Mark Nadel points out, copyright protections cause revenues from the most popular works to increase more than the revenues of marginally viable works.<sup>54</sup> The result is that the most popular works capture even more of the market than they would in a regime of weaker copyright protections, and labels use that profit to promote their works and capture the market share that would otherwise be available to marginal competitors.<sup>55</sup> As Nadel posits, the current copyright regime maximizes the revenues associated with the most popular works, which leads to the following outcome:

[Higher revenues allow] publishers of the most popular works to disproportionately increase their marketing efforts, forcing publishers of marginal works to either 1) spend even more money on marketing simply to retain their sales and revenues or 2) refrain from further increasing marketing expenditures, but see their works' sales and revenues

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<sup>53</sup> Nadel, *supra* note 18, at 794-95.

<sup>54</sup> *Id.* at 794.

<sup>55</sup> *Id.* at 801-03.

decline. In either case, the increased marketing costs or decreased revenues triggered by § 106 likely lead many otherwise marginally profitable creative projects to become unprofitable and therefore to no longer be produced.<sup>56</sup>

Under this analysis, copyright law is actually too strong, and protects the most popular works at the expense of more marginally popular artistic creation.

The result of the strong copyrights afforded to creative works coupled with the oligopolistic nature of the industry leads to a situation in which small artists, who are unrepresented by the major distributors, are unable to break into the marketplace. Rather than promoting the creation of more music, then, copyright law in this context suppresses competition by giving larger profits to the major labels, which in turn use those profits to shut out competitors. This is a product of the way the market operates, particularly with respect to the higher marketing costs needed to promote a new song, the cooperative advertising fees needed to win retailer shelf space and the independent promotion fees needed to garner radio airplay. Without the marketing budget to pursue these promotional avenues, lesser-known and new artists are unable to gain access to the public. The result is that there is less incentive to create music because it is harder to become well known and profitable. In other words, the artists who “win” the lottery by signing with a major distributor are in a position to reap massive profits compared to the independent artists who may not be able to gain even minimal access to the public. However, the

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<sup>56</sup> *Id.* at 802-03.

independent artists are not the only losers in this scenario. Because these independent artists are unlikely to succeed, they are less likely to produce new music – and the public loses. Understanding that this is the way the market functions is an important backdrop against which one must view emergent file sharing technologies. Section II of this Article will argue that, contrary to popular belief, file sharing technologies actually increase innovation by lowering distribution costs, weakening the major labels' grip on channels of distribution and enabling smaller artists to gain access to the marketplace.

## II. PEER-TO-PEER FILE SHARING INCREASES INNOVATION

There is significant literature on the impact of peer-to-peer file sharing on innovation.<sup>57</sup> While common intuition would lead most casual observers to conclude that illegal file sharing erodes copyright protections and decreases incentives to create music, this section will argue for the opposite conclusion. This section aims to contribute to the literature by articulating the ways in which file sharing has a disparate impact on different segments of the artistic community. Further, it contends that even illegal file sharing, paradoxically, has the net effect of *increasing* artistic innovation (at least in the short run).

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<sup>57</sup> See, e.g., Garrett Levin, *Buggy Whips and Broadcast Flags: The Need for a New Politics of Expression*, 2005 DUKE L. & TECH. REV. 24 (2005); Jessica Litman, *Law Technology & The Arts Symposium: "Copyright and Personal Copying: Sony v. Universal Studios Twenty-one Years Later": The Sony Paradox*, 55 CASE W. RES. L. REV. 917 (2005); Justin Hughes, *On The Logic of Suing One's Customers and The Dilemma of Infringement Based Business Models*, 22 CARDOZO ARTS & ENT. L.J. 725 (2005); Mark A. Lemley & R. Anthony Reese, *Reducing Digital Copyright Infringement without Restricting Innovation*, 56 STAN. L. REV. 1345 (2004).

**A. How the Technology Works**

Several technologies simultaneously emerged to cause the file sharing controversy that has rocked the music industry to its core. One is the development of “MP3,” or “MPEG-1 Audio Layer III” compression technology. Music files were traditionally stored in the “WAV” format, which maintained the pristine quality of compact disc recordings but took up large amounts of storage capacity. MP3 compression technology works by eliminating from an audio file those frequencies that are not recognized by the human ear.<sup>58</sup> Thus, an MP3 file maintains high quality audio sound and requires much less storage capacity than a regular audio file. MP3 files are usually compressed to between one-tenth and one-twelfth the size of the original audio file. Another significant feature of MP3 files is that they are digital quality. Audiocassettes (which are not digital) can be repeatedly copied, but each successive copy suffers some degradation in quality. In contrast, an MP3 can be repeatedly copied without any corresponding loss in quality. This allows for the viral spread of MP3s and the virtually exponential growth of MP3 sound files across a file sharing network.

Another technological development which paved the way for the file sharing revolution was the deployment of affordable broadband Internet access to homes and college dorm rooms across the United States. Broadband access allows users to connect to the Internet and has two important advantages over conventional Internet

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<sup>58</sup> MP3 For The Mac, What is MP3, How Does it Work, What is MPEG?, [http://www.mp3-mac.com/Pages/What\\_is\\_MP3.html](http://www.mp3-mac.com/Pages/What_is_MP3.html) (last visited Mar. 9, 2006).



connections obtained through a regular phone line. One advantage to broadband is that it does not occupy a phone line but has its own dedicated connection to the Internet, meaning that it is always “on.” Secondly, broadband connections transmit data at speeds as high as four million bits per second, which can be seventy times faster than the speed of a standard modem connected to the Internet over a telephone line.<sup>59</sup>

Finally, the development of file sharing software coincided with the advent of the MP3 file format and greater broadband access to facilitate the widespread use of file sharing. The relevant software, which exists in several forms, can broadly be described as file sharing technology. The moniker is an apt one, since it accurately describes the function of the software, which is to exchange any kind of data between computers connected to one another or to the Internet. File sharing technology essentially creates a worldwide library through which millions of computers are connected to one another, with each user enjoying access to the files on each of the connected computers. Obviously, there are network externalities in such an arrangement: the more computers connected to one another, the more files available, and the more valuable the network. This feature of the file sharing networks explains the rapid-fire growth of Napster and its progeny. There are two basic file sharing models: the first is the Napster model, and the second model is the decentralized model.

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<sup>59</sup> Comcast Features, <http://comcast.com/Benefits/CHSIDetails/Slot5PageOne.asp> (last visited Mar. 9, 2006) (providing the latest features for Comcast, a broadband Internet service provider).

### 1.      *The Napster Model*

Napster was created in 1999 by a college undergraduate named Shawn Fanning.<sup>60</sup> Napster's success can be attributed to its simplicity. Users with access to the Internet could log on to Napster's website on the World Wide Web and download the Napster software at no cost. The software compiled a catalog of MP3 files on the user's hard drive. Napster then stored a copy of the catalog on its central servers, which would be available for other Napster users to view.<sup>61</sup> Napster allowed its users to search a combined catalog of files available on the network at any given time and enabled users to directly connect with any other user's computer to download the desired files to their own computers.<sup>62</sup> Hence, Napster facilitated the exchange of files between computers by maintaining a catalog of files on its central servers and by using its file transfer protocol to enable computers to exchange files with one another. However, Napster itself did not possess or store any of the music files being transferred. Because the files were being exchanged from one user to another, this type of file sharing came to be known as "peer-to-peer" or "p2p" file sharing.

### 2.      *The Decentralized Server Model*

The second type of file sharing software works similarly to Napster, but the services using this type of software do not maintain a

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<sup>60</sup> Lior Jacob Strahilevitz, *Charismatic Code, Social Norms, and the Emergence of Cooperation on the File-Swapping Networks*, 89 VA. L. REV. 505, 511 (2003).

<sup>61</sup> *Id.* at 512.

<sup>62</sup> *Id.* at 511-12.

central server that catalogs the available files. There are different variants within this category of software, but the programs generally allow a user to conduct a search for audio files, video files or other types of files using criteria such as artist, song name, or album name. The user's computer then checks with every computer connected to it for files that match the search criteria. These computers, in turn, search each of the computers to which they are connected for the relevant files, and these computers check the computers to which they are connected, and so on.<sup>63</sup> The website <http://www.zeropaid.com>, which functions as a resource for peer-to-peer file sharing users, currently lists one hundred eleven file sharing programs for the Windows operating system.<sup>64</sup> The most popular of these file sharing programs is KaZaA, which reports that its software has been downloaded over 389,000,000 times as of May 5, 2005.<sup>65</sup>

The new MP3 compression format, widespread and faster Internet access, and the development of file sharing technology all merged in confluence to facilitate what Lior Strahilivetz has called "arguably the largest international networks of illegality in human history."<sup>66</sup> In addition to becoming a cultural phenomenon and a household name, Napster enrolled seventy million users worldwide at its peak.<sup>67</sup> Since then, music file sharing software has continued to erupt. Sixty million Americans, or half of all Internet users in the

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<sup>63</sup> *Id.* at 516-17.

<sup>64</sup> Zeropaid, <http://www.zeropaid.com> (last visited Apr. 11, 2006).

<sup>65</sup> KaZaA, <http://www.kazaa.com/us/index.htm> (last visited Apr. 11, 2006).

<sup>66</sup> Strahilevitz, *supra* note 60, at 507.

<sup>67</sup> Eliza S. Clark, *Online Music Sharing in a Global Economy: The U.S. Effort to Command (or Survive) the Tidal Wave*, 14 MINN. J. GLOBAL TRADE 141, 141-42 (2004).

United States, have used peer-to-peer networks to exchange files.<sup>68</sup> At a given moment, five million Americans are participating in file sharing, collectively downloading to their personal computers an astonishing 2.6 billion files a month.<sup>69</sup> Of these 2.6 billion files, the Recording Industry Association of America (“RIAA”) claims that two billion are illegally traded music files.<sup>70</sup> Obviously, peer-to-peer file sharing networks have forever changed the music industry. But turning back to our original question of whether the current regime yields the socially optimal level of creative output, do the existence of file sharing networks help or hinder creative innovation?

### **B. Empirical Evidence Shows That File Sharing Does Not Harm Record Sales**

Common sense would seem to dictate that the file sharing networks erode incentives to engage in artistic endeavors. After all, copyright laws exist to encourage creation,<sup>71</sup> and file sharing networks weaken copyrights by allowing users to illegally transfer copyrighted works at no cost. This belief underlies the music industry’s avid efforts to curb peer-to-peer file sharing, including its radical act of suing thousands of its own consumers.<sup>72</sup> Indeed, the

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<sup>68</sup> Stacey M. Lantagne, *The Morality of Mp3s: The Failure of the Recording Industry's Plan of Attack*, 18 HARV. J.L. & TECH. 269, 273 (2004).

<sup>69</sup> *Id.*

<sup>70</sup> Hillary M. Kowalski, *Peer-To-Peer File Sharing and Technological Sabotage Tactics: No Legislation Required*, 8 MARQ. INTELL. PROP. L. REV. 297, 312 n.95 (2004).

<sup>71</sup> See John Schietinger, *Bridgeport Music, Inc. v. Dimension Films: How the Sixth Circuit Missed a Beat on Digital Music Sampling*, 55 DEPAUL L. REV. 209, 215 (2005) (stating that the two purposes of copyright law are: (1) to encourage creation, and (2) to protect authors from theft of their copyrightable works).

<sup>72</sup> Kristina Groennings, *Costs and Benefits of the Recording Industry's Litigation Against Individuals*, 20 BERKELEY TECH. L.J. 571, 571-72 (2005). “As of November 11, 2004, a

record industry asserts that compact disc sales fell from 940 million to 800 million, or 15%, between 2000 and 2002, a time period corresponding with a rapid increase in the use of file sharing software.<sup>73</sup> While defenders of file sharing point out that the fall in record sales may be due to a corresponding economic downturn, the industry's claim is supported by the fact that alternate forms of entertainment dependent on discretionary income, such as movie ticket sales, did not suffer from a similar decline.<sup>74</sup>

Nonetheless, the effect of file sharing on record sales is ambiguous. On the one hand, users are less likely to purchase copyrighted musical works if they can easily obtain those same works for free. Obviously, if the file-sharers trading songs in the billions were instead purchasing those albums, the record industry would be enjoying far greater revenues. Conversely, users of file sharing networks are able to access many new songs and artists to which they would not otherwise be exposed. By sampling a few songs from a new artist, users might be impressed enough to legally purchase a compact disc they would not have otherwise purchased.

Anecdotally speaking, a colleague reports that in his previous job a co-worker gave him an illegally copied compact disc obtained from a file sharing network. After enjoying the music he heard, this

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total of 6,200 file-sharers had been targeted in a litigation strategy that, since its inception, has been marked by unprecedented media coverage and public scrutiny." *Id.*

<sup>73</sup> FELIX OBERHOLZER & KOLEMAN STRUMPF, THE EFFECT OF FILE SHARING ON RECORD SALES: AN EMPIRICAL ANALYSIS, 1-2 (Mar. 2004), [http://www.unc.edu/~cigar/papers/FileSharing\\_March2004.pdf](http://www.unc.edu/~cigar/papers/FileSharing_March2004.pdf) (last visited Mar. 15, 2006).

<sup>74</sup> See, e.g., BoxOfficeMojo.com, Yearly Box Office Chart, <http://www.boxofficemojo.com/yearly/> (last visited Mar. 15, 2006) (showing that domestic box office revenues during this time period steadily rose from \$7.6 billion in 2000, to \$8.4 billion in 2001, to \$9.16 billion in 2002).

colleague went on to purchase not only the compact disc which he had indirectly obtained through an illegal file sharing network, but he also purchased all of the group's other albums, their DVD documentary and tickets to several of their live shows.

File sharing networks therefore have two opposite effects on the market for music: they undercut incentives to legally purchase music, but they also work as a cheap distribution mechanism that effectively promotes artists.<sup>75</sup> These opposite effects underlie the debate as to whether file sharing actually harms artists and discourages innovation. As the Supreme Court recently prepared to hear arguments regarding the legality of decentralized file sharing networks such as KaZaA, the RIAA and most well-known recording artists urged the Court to hold these networks liable for contributory infringement.<sup>76</sup> However, a number of prominent musicians and artists defied the industry's stance by urging the Supreme Court to find the file sharing networks not guilty of contributory infringement

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<sup>75</sup> Internationally, this second effect appears to be the only incentive for artists to create music in some markets. See Kevin Maney, *If Pirating Grows, it May Not be the End of Music World*, May 3, 2005, [http://www.usatoday.com/tech/columnist/kevinmaney/2005-05-03-music-piracy-china\\_x.htm](http://www.usatoday.com/tech/columnist/kevinmaney/2005-05-03-music-piracy-china_x.htm) (last visited Mar. 16, 2006).

Yu Quan, like every music act in China, gets almost no income from CD sales, even though millions of its CDs have been sold. As soon as a CD is made, the pirates are on the street, offering them for a fraction of the retail price. Stores sell pirate copies. Legitimate CDs all but vanish. So artists have to regard CDs as essentially promotional tools, not as end products. Yu Quan makes money by performing concerts, getting endorsement deals and appearing in commercials. If people hear and like Yu Quan's songs on pirated CDs, at least they'll be more likely to come to the concerts and buy what the duo endorses.

*Id.*

<sup>76</sup> Brief for Recording Artists' Coalition et al. as Amici Curiae Supporting Petitioners at 2-3, *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 125 S. Ct. 2764 (2005) (No. 04-480) (stating that the "[a]mici have an extremely strong interest in . . . overturning the Ninth Circuit's ruling that Respondents did not engage in contributory copyright infringement by

and to uphold their legality.<sup>77</sup> In a draft of the group's amicus brief filing, the artists argue, "[m]usicians are not universally united in opposition to peer-to-peer file sharing. To the contrary, many musicians find peer-to-peer technology . . . allows them easily to easily reach a worldwide online audience. And to many musicians, the benefits of this . . . outweigh the risks of copyright infringement."<sup>78</sup> Along these lines, artist Jason Mraz stated that half of the audience purchasing tickets to his live performances learn of his music through illegal file sharing.<sup>79</sup>

Given the tremendous impact of file sharing networks and the debate over the harm that file sharing networks perpetrate against recording artists, scholars have turned to empirical data to understand the impact of file sharing on record sales in the music industry. The studies have yielded mixed results. Researcher Aram Sinnreich's studies show that file sharing may actually increase sales of albums.<sup>80</sup> Sinnreich claimed that "[w]hile some people seemed to buy less after file sharing, more people seemed to buy more . . . . It was more likely to increase somebody's purchasing habits."<sup>81</sup> In fact, "people who traded files for more than six months were 75 percent more likely than average online music fans to spend more money on

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creating and distributing such peer-to-peer services").

<sup>77</sup> See Brief for Sovereign Artists on Behalf of Ann Wilson & Nancy Wilson (Heart) et al. as Amici Curiae Supporting Respondents at 13, *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 125 S. Ct. 2764 (2005) (No. 04-480).

<sup>78</sup> *Id.* at 13.

<sup>79</sup> *Id.* at 21.

<sup>80</sup> See David McGuire, *Study: File-Sharing No Threat to Music Sales*, March 29, 2004, <http://www.washingtonpost.com/ac2/wp-dyn/A34300-2004Mar29> (last visited Mar. 16, 2006).

<sup>81</sup> *Id.*

music.”<sup>82</sup> The music industry, of course, has countered with its own studies. According to Amy Weiss, a spokesperson for the RIAA, “[c]ountless well respected groups and analysts, including Edison Research, Forrester, the University of Texas, among others, have all determined that illegal file sharing has adversely impacted the sales of CDs.”<sup>83</sup>

The best-known study of the impact of file sharing on record sales is one released in March 2004, and conducted by Felix Oberholzer of the Harvard Business School and Koleman Strumpf of the University of North Carolina at Chapel Hill.<sup>84</sup> The researchers behind this study claim that theirs is the most accurate empirical analysis because it is the only one that is based on the direct observation of actual file sharing transactions made by users who are unaware that they are being observed.<sup>85</sup> Oberholzer and Strumpf’s ultimate conclusion is that file sharing essentially has no effect on record sales.<sup>86</sup> They state that file sharing “has no statistically significant effect on purchases of the average album in our sample. Moreover, the estimates are of rather modest size when compared to the drastic reduction in sales in the music industry. At most, file sharing can explain a tiny fraction of this decline.”<sup>87</sup> According to Oberholzer and Strumpf, their study is significant in that it “provides the first serious evidence that file sharing cannot explain the decline

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<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> See Oberholzer, *supra* note 73.

<sup>85</sup> *Id.* at 6.

<sup>86</sup> *Id.* at 3.

<sup>87</sup> *Id.* at 24.



in music sales in the last couple of years.”<sup>88</sup>

The study created significant controversy within the music industry and in an interview several months after the release of the study, Oberholzer provided the following evidence to support his conclusions: “[I]n the last two quarters, music sales increased while file sharing has become even more popular. BigChampagne.com, an Internet monitoring firm, estimates that there are now up to 9 million simultaneous file sharers, up from about 4 million in early 2003.”<sup>89</sup> Because the record industry used evidence of a correlation between the rise of file sharing and the decline in compact disc sales to draw a causal link, the findings reported by Oberholzer tug in the opposite direction. Of course, the correlation between increased file sharing and decreased record sales several years ago and between increased file sharing and increased record sales in the past year do not imply a causal link in either direction. But the ambiguity of that evidence, coupled with the empirical study conducted by Oberholzer and Strumpf, at the very least casts doubt upon the record industry’s contention that file sharing has driven down sales and harms innovation. So long as the empirical data is ambiguous, we cannot definitely determine one way or another whether file sharing increases or decreases record sales, and, in turn, encourages or discourages innovation. As the next segment will argue, however, the mere fact that the net effect of file sharing on record sales is probably negligible means that, given the way the market is

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<sup>88</sup> Sean Silverthorne, *Music Downloads: Pirates—or Customers*, June 21, 2004, <http://hbswk.hbs.edu/item.jhtml?id=4206&t=innovation> (last visited Mar. 16, 2006).

<sup>89</sup> *Id.*

structured, file sharing actually increases incentives for artists to innovate.

**C. File Sharing Benefits Small Artists and Increases Their Incentives to Innovate**

*1. Small Artists Are Dissimilarly Situated From Large Artists*

The current literature discussing the impact of file sharing on music sales presumes a class of homogenous, uniformly interested musicians who are equally harmed or helped by file sharing. This is hardly an apt description of reality. While the impact of file sharing on the industry as a whole may be neutral, file sharing impacts different segments of the artistic community in vastly different ways. As this Article argued in Part I, there is a division between the great majority of artists, who are unrepresented by one of the five major distributors, and the select few who are.<sup>90</sup> There is no empirical evidence how file sharing impacts these segments of the industry differently, but an understanding of the market's structure suggests that smaller, independent artists may benefit from file sharing while larger artists with entrenched fan bases may stand to lose. Robert Boies, the lawyer defending Napster in its RIAA lawsuit, articulated this concept as follows:

The Internet is both a threat and an opportunity. It is an opportunity to efficiently promote and build demand. It is a threat because it is a distribution and promotion channel that the record labels, at least for

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<sup>90</sup> See *supra* Part I.B.

now, do not control. It is the greatest opportunity for the 98 percent of artists that are not distributed by the major record labels. It is the greatest threat to the RIAA and its members.<sup>91</sup>

It makes sense that two segments of the market, which are situated so differently from one another, will be dissimilarly impacted by emerging technologies that alter the way in which their products are distributed. The net effect of file sharing on incentives for innovation will therefore depend on the interaction between the effect of file sharing on small artists and the effect on large artists carried by one of the major labels.

## 2. *Small Artists Unrepresented by a Major Label Benefit From Illegal File Sharing*

For the vast majority of artists who are unrepresented by one of the five major labels – 98% of professional musicians, according to Robert Boies<sup>92</sup> – file sharing actually increases compensation and incentives to create new songs. Part I of this Article described how the current structure of the music industry works to inhibit competition.<sup>93</sup> By controlling mechanisms of distribution such as radio and retail store shelf space, the major labels ensure that only those artists they represent have access to the public. They are able to control access to the public by engaging in policies that drive up the costs of distribution. Peer-to-peer file sharing networks tear

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<sup>91</sup> Matthew Mirapaul, *Is It Theft, or Is It Freedom? 7 Views of the Web's Impact on Culture* *Clashes*, Sept. 20, 2000, <http://partners.nytimes.com/library/tech/00/09/biztech/technology/20mirapaul.html> (last visited Mar. 20, 2006).

<sup>92</sup> *Id.*

<sup>93</sup> See *supra* Part I.B.

down these barriers by making distribution costs virtually zero. Any artist can post songs or samples of songs on a publicly accessible website or upload them to the file sharing networks that traffic billions of songs a month, and thereby disseminate his or her music to countless listeners for free. Peer-to-peer file sharing networks functioning in this way can be viewed as “the new radio” – only now, major record labels are not able to block out competitors by engaging in pay-for-play practices.

### 3. *Artists Support the Notion That File Sharing Promotes Their Careers*

The Pew Internet Project, an independent research group that monitors public opinion, released a study in December of 2004 which reports that artists and musicians “have embraced the Internet as a tool that helps them create, promote, and sell their work.”<sup>94</sup> The study found that artists generally believed that file sharing was more beneficial to their careers than harmful. The survey yielded the following results: “37% of those in [the] sample say free downloading has not really made any difference . . . and 15% of the [artists] say they don’t know.”<sup>95</sup> Meanwhile, “35% [of the artists] say [free downloading] has helped, and 8% say it has both helped and hurt their career. [Finally,] [o]nly 5% say free downloading has exclusively hurt their career.”<sup>96</sup>

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<sup>94</sup> Mary Madden, Artists, Musicians, and the Internet (2004), [http://www.pewInternet.org/pdfs/PIP\\_Artists.Musicians\\_Report.pdf](http://www.pewInternet.org/pdfs/PIP_Artists.Musicians_Report.pdf) (last visited Mar. 16, 2005).

<sup>95</sup> *Id.* at 35.

<sup>96</sup> *Id.*

The survey is notable in that it sampled the opinions of 2755 self-described musicians and songwriters between March and April of 2004, a sample which ranges much more broadly than one which considers only the opinions of artists represented by the major labels. One might therefore expect different results from a survey conducted by the RIAA, which only samples the opinions of its constituents. However, in understanding the effects of file sharing on the creation of music, it is essential to consider its effects on all segments of the music industry, and as this study makes clear, more artists believe that file sharing is helpful to their careers than harmful. Viewed in this light, file sharing technologies can be viewed as a technological breakthrough that flattened the playing field by enabling many more artists to distribute their music.

#### 4. *The Wilco Story*

The idea that file sharing helps smaller artists is not only compelling in theory, but has real world examples. When the rock-group Wilco presented its signature album *Yankee Hotel Foxtrot* to record executives at their label Reprise Records, they were asked to alter their music to make it more “mainstream.” Wilco refused, and Reprise Records terminated their record contract.<sup>97</sup> In another era, this may have been the end of the story. However, Wilco released its entire album onto file sharing networks for free, allowing its songs to circulate across the Internet for a year in order to generate buzz and

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<sup>97</sup> S. Renee Dechert, “*It Feels Like Christmas*” – *Or the Story of How Wilco Gave Itself Creative Freedom*, Apr. 23, 2002, <http://www.popmatters.com/music/reviews/w/wilco-yankee.shtml> (last visited Mar. 16, 2006).

fan interest. The strategy was a success; when *Yankee Hotel Foxtrot* was finally distributed on a compact disc as a commercial release, it sold more than 50,000 copies in its first week – more than twice as many copies as its previous album had sold in its first week.<sup>98</sup>

The Wilco story is not unique. File sharing technology has benefited countless independent artists who operate outside the world dominated by the five major labels. While overall album sales dropped by 11% in 2002, and executives at the five big labels were “wail[ing] about the industry’s imminent collapse,” many independent labels and artists were enjoying profits that increased at a rate of 50% to 100%.<sup>99</sup> Undoubtedly, these artists enjoyed increased prominence due, at least in part, to the fact that file sharing technologies enabled them to reach a worldwide audience for the first time.

#### **D. The Impact of File Sharing on Large Artists Is Unclear, but File Sharing Is Unlikely to Deter Them From Creative Innovation**

While a compelling case can be made that small, independent artists benefit from the file sharing revolution, what about larger artists who are represented by the major labels? Are they harmed by file sharing? And if so, do their losses outweigh the gains being made by independent artists? Logic dictates that if the overall effect

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<sup>98</sup> Brian Mansfield, *When Free is Profitable*, May 20, 2004, [http://www.usatoday.com/life/music/news/2004-05-20-file-sharing-main\\_x.htm](http://www.usatoday.com/life/music/news/2004-05-20-file-sharing-main_x.htm) (last visited Mar. 16, 2006).

<sup>99</sup> Lynne Margolis, *Independents’ Day: What Record Industry Slump? Independent Labels Say Business Has Never Been Better*, Apr. 11, 2003, <http://www.csmonitor.com/2003/0411/p13s02-alm.html> (last visited Mar. 16, 2006).

of file sharing on record sales is negligible, and that the 98% of artists who are not represented by major labels are enjoying increased sales, then the 2% of artists who are carried by the major labels must be suffering from declining sales. This makes sense when one considers the logistics of the music industry and file sharing networks. Ordinarily, record companies heavily promote one or two singles from an artist's album, but in order to purchase these songs a consumer must purchase the entire album containing ten to fifteen songs for \$17 or \$18. File sharing networks undermine this model by allowing users to download the one or two popular singles without having to purchase the entire album.<sup>100</sup> Thus, peer-to-peer file-sharers are often downloading the songs that are already on the radio and which are being heavily promoted by one of the five major labels. Moreover, due to network externalities, the more popular a song is, the more often it will be traded online, making it easier for other users to find the same song, which in turn generates more online trading. Thus, file sharing negatively impacts well-established artists whose music is already publicized and would be purchased even in the absence of the free advertising provided by file sharing networks.

From the perspective of compensating artists for their work, this fact weighs in favor of dismantling file sharing networks so that artists receive fair compensation for their labor. But solely from the perspective of generating the socially optimal amount of creative

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<sup>100</sup> See Silverthorne, *supra* note 88. "[F]ile sharers do not download entire CDs. We do not know why they sample only a few songs." *Id.*

content, the fact that file sharing networks are primarily used to transfer the files of the most popular artists may be irrelevant for two reasons. One reason is that it is often the distributors, and not the artists themselves, who financially gain from record sales. Second, even if the popular artists receiving heavy radio airplay do suffer financial losses, they are already well enough established and earning enough profits that the marginal loss in revenues is unlikely to persuade them to quit their trade.

*1. Illegal File Sharing May Not Harm Artists  
Since Record Labels Recoup Most of the  
Profits From Album Sales*

The first reason that file sharing may not reduce innovation even though large artists suffer declining sales is that they may not suffer a corresponding drop in income. Typically, labels sign artists to exploitative contracts where the musicians become celebrities and the labels retain a majority of the profits. Beau Brashares, a musician and lawyer, describes how artists may receive only 10% royalties from sales of an album, from which all expenses are deducted, including expenses related to recording, manufacturing and promotion.<sup>101</sup> If an album is successful, the incentive structure is such that the label is motivated to continue spending the band's money to promote the album and generate more sales since it is recouping 90% of the revenues.<sup>102</sup> Brashares describes the deal

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<sup>101</sup> WILLIAM W. FISHER, *PROMISES TO KEEP: TECHNOLOGY, LAW, AND THE FUTURE OF ENTERTAINMENT*, 20 (Stanford U. Press) (2004).

<sup>102</sup> *Id.*



between label and artist as follows:

If the record looks like a hit, the label will keep spending the band's small share on more pressing, promoting, and so on . . . . This is why a major release frequently needs to sell 500,000 copies – go gold – before sales proceeds begin reaching the band's pockets . . . . All in all, the deal offered to artists by a major record label is, you get the glory, and we get the money.<sup>103</sup>

The sample breakdown of how record sale royalties are distributed,<sup>104</sup> along with the anecdotal evidence provided by Brashares, illustrate how artists are often deprived of revenues when their record labels water down their royalty payments.<sup>105</sup> For example, the Backstreet Boys, one of the most popular bands of the 1990s, did not receive any royalties from their millions of album sales.<sup>106</sup> In addition, Mickey Melchiondo, a member of the group Ween, has stated, “I don’t have sympathy for the record companies . . . they haven’t been paying me royalties anyway.”<sup>107</sup> Meanwhile, Roger McGuinn, a leader of the popular band The Byrds in the 1960s, reports that his band’s early albums netted him only 0.0007 cents per album sold.<sup>108</sup> He did not

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<sup>103</sup> *Id.*

<sup>104</sup> *See infra* Appendix II.

<sup>105</sup> *See* FISHER, *supra* note 2, at 55-56 (providing an additional sample calculation of an artist’s royalty earnings in which expenses are deducted from royalties); *id.* at 55 n.28 (drawing upon figures provided by DONALD S. PASSMAN, *ALL YOU NEED TO KNOW ABOUT THE MUSIC BUSINESS*, 55-126 (Prentice Hall Press) (1991) and from M. WILLIAM KRASILOVSKY & SIDNEY SHEL, *THIS BUSINESS OF MUSIC*, 3-23 (Billboard Books 6th ed., 1990) (1964)). While royalties in most industries are generally calculated from net revenues (in other words, expenses for which the artist is responsible are subtracted from the gross revenue), the aforementioned authorities demonstrate that it is standard practice in the music industry for expenses to be deducted from the royalties themselves.

<sup>106</sup> Neil Strauss, *File-Sharing Battle Leaves Musicians Caught in Middle*, N.Y. TIMES, Sept. 14, 2003, at § 1.

<sup>107</sup> *Id.*

<sup>108</sup> *See* Maney, *supra* note 75 (providing a more detailed account of Roger McGuinn’s

receive any royalties from the sales of *Back from Rio*, his solo album that sold half a million copies.<sup>109</sup> In fact, the only album on which he claims to have ever made a profit is his most recent album, which he recorded on his own laptop computer without the help of a record label.<sup>110</sup> Instead of marketing his new record through a label, McGuinn sells copies of it online and at concerts – after posting all the songs online for *free*.<sup>111</sup>

The evidence above suggests that even the artists represented by one of the five major labels may not suffer any significant loss from illegal file sharing because the losses are borne by the labels themselves.<sup>112</sup> Senator Orrin Hatch has described how

[t]he Internet generally (and peer-to-peer file sharing technology in particular) . . . makes possible direct dissemination of creative works with essentially no reproduction or distribution costs. That is very exciting, but frightening to the mediators who have added value by helping with the previously costly processes of copying and distributing.<sup>113</sup>

Under this analysis, it is the labels, and not the major artists, who are most likely to suffer from illegal file sharing, and if the artists are not suffering pecuniary losses they are unlikely to curb their own

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struggles with the music industry).

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> An important caveat to this claim is that the most well-established artists may earn royalties far more lucrative than those represented by the figures in Appendix II. One reason is that their fame allows the best-known artists to negotiate better deals with their record labels. Secondly, artists sell more albums which leads to correspondingly higher royalties. See, e.g., FISHER, *supra* note 2, at 58 (describing some of the ways in which a famous artist, such as Paul Simon, may earn substantial royalties).

<sup>113</sup> See Mirapaul, *supra* note 91.

creativity.

2. *Illegal File Sharing Provides Artists With Free Marketing That Is Likely to Promote Concert Ticket Sales, Merchandising Opportunities, and Other Ancillary Benefits*

The second reason that file sharing is unlikely to discourage innovation by established artists is that the artists whose music is most frequently traded online have already established a presence on the radio and in popular culture. For these artists, file sharing may harm record sales (from which they may or may not be earning royalties), but they also promote the artist's songs and create additional opportunities for revenue from such avenues as merchandising and touring. Additionally, these artists will often be motivated by non-monetary values such as the desire for fame. There may be a small number of well-established artists at the margin for whom the declining revenues from record sale royalties will be a sufficient disincentive to create music. But even for well-established artists, it may very well be the case that, on the whole, file sharing increases their revenues by increasing their ability to make money through other means such as concert tours. Even for those artists who are harmed by file sharing, it is unlikely that file sharing will cause these artists to stop innovating. The few well established artists signed to a big label will likely continue to produce music, even if they suffer a slight loss in their royalties.

**E. File Sharing Networks Ultimately Encourage Innovation, but May Be Driven Out of Business**

If the sole purpose of the copyright regime is to encourage the proper amount of innovation, it appears that file sharing networks provide an enormous boost to creativity. The preceding argument demonstrates that the vast majority of artists, who are not represented by a large label, undoubtedly benefit from the opportunity to disseminate their work at virtually no cost through file sharing networks. For those artists who are signed to a major label, whether or not the benefits associated with illegal file sharing outweigh the harms is contingent on the particular circumstances surrounding that artist. Nonetheless, even the artists who are clearly harmed by file sharing are unlikely to suffer enough of a disincentive to stop producing music. Therefore, the record industry's claim that file sharing networks undercut innovation is tenuous at best. If anything, this technology is likely to increase innovation in the long run by enabling more artists to overcome the music industry's restrictive barriers to entry.

Unfortunately, for proponents of the current culture of peer-to-peer file sharing, the existing legal regime with respect to copyright is unreceptive to these types of arguments and may suppress the peer-to-peer file sharing revolution in its infancy. Much has been written about the litigation regarding the peer-to-peer file sharing networks, so what follows is only a brief review.<sup>114</sup> In the

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<sup>114</sup> See e.g., John M. Moye, *How Sony Survived: Peer-To-Peer Software, Grokster, and Contributory Copyright Liability in the Twenty-First Century*, 84 N.C. L. REV. 646 (2006); Nicholas M. Menasche, *Recording Industry Missteps: Suing Anonymous Filesharers as a*

first landmark case to address this issue, the Ninth Circuit granted a preliminary injunction shutting down the Napster file sharing network.<sup>115</sup> The court held that Napster was guilty of contributory copyright infringement because it knowingly made a material contribution to the infringement of the plaintiffs' copyrighted works.<sup>116</sup> The court also held that the plaintiffs demonstrated a likelihood of success on a vicarious copyright infringement claim because Napster had a financial interest at stake and had the power to supervise its users.<sup>117</sup> Though Napster reincarnated itself as a subscription service for the legitimate transfer of copyrighted works, it never regained its initial popularity.<sup>118</sup> More recently, in *MGM v. Grokster*,<sup>119</sup> the Supreme Court held that online distribution services utilizing the decentralized model are also guilty of contributory copyright infringement.<sup>120</sup>

In addition to the judicial rulings, file sharing services are in danger of being shut down due to Congressional action. Senator Orrin Hatch has introduced the "Inducing Infringement of Copyrights

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*Last Resort*, 26 PACE L. REV. 273 (2005); Seth A. Miller, *Peer-To-Peer File Distribution: An Analysis of Design, Liability, Litigation, and Potential Solutions*, 25 REV. LITIG. 181 (2006); Robyn Axberg, *File-Sharing Tools and Copyright Law: A Study of In re Aimster Copyright Litigation and MGM Studios, Inc. v. Grokster, LTD.*, 35 LOY. U. CHI. L.J. 389 (2003).

<sup>115</sup> *A&M Records, Inc. v. Napster, Inc.* 239 F.3d 1004, 1027 (9th Cir. 2001) (holding that "[t]he district court correctly recognized that a preliminary injunction against Napster's participation in copyright infringement is not only warranted by required").

<sup>116</sup> *Id.* at 1021-22.

<sup>117</sup> *Id.* at 1024.

<sup>118</sup> Andrew Orłowski, *Napster Does the Maths*, Feb. 10, 2005, [http://www.theregister.co.uk/2005/02/10/napster\\_2q\\_2005/](http://www.theregister.co.uk/2005/02/10/napster_2q_2005/) (last visited Mar. 16, 2006) (noting that in the year 2003, "Napster lost \$41 million on net revenues of \$6.69m.").

<sup>119</sup> 125 S. Ct. 2764 (2005).

<sup>120</sup> *Id.* at 2770 ("[O]ne who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster

2006] *THE ANTI-COMPETITIVE MUSIC INDUSTRY* 427

Act,”<sup>121</sup> which targets any product that induces copyright infringement. The bill targets the types of file sharing services that were held liable in the Court’s recent *Grokster* ruling, but has come under fire because of its broad language and possible application against what are viewed as more legitimate products and services such as portable MP3 players. The bill has not passed this session, but Senator Hatch has voiced his intention to reintroduce the legislation next legislative term.<sup>122</sup> Clearly, the file sharing networks which facilitate billions of illegal transactions of copyrighted works – but also have the counterintuitive effect of spurring innovation – are under attack from both the judicial and legislative branches.

If the networks are ultimately shut down, a revolutionary technology which has broken down barriers and allowed countless new artists to enter the market will be stunted and the crumbling status quo restored. However, the opposite result, a world in which these file sharing networks are legal and continue to thrive, seems suboptimal from the perspective of fairness. Such a resolution may indeed promote the socially optimal amount of creative innovation, but may be normatively deficient in that well-respected artists would fail to be compensated for their labor. Moreover, such an outcome may lead to a loss of respect for the rule of law and a cultural tolerance for theft, as millions of Americans would be engaging in theft and copyright infringement everyday. If shutting down file

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infringement, is liable for the resulting acts of infringement by third parties.”).

<sup>121</sup> Inducing Infringement of Copyrights Act, S. 2560, 108th Cong. (2004).

<sup>122</sup> Ted Bridis, *Senate Talks Fail on File-Sharing Software*, Oct. 7, 2004, <http://msnbc.msn.com/id/6200562/> (last visited Apr. 11, 2006).

sharing networks will stifle a promising technology, while legalizing file sharing services which facilitate theft is normatively deficient, we are left to wonder whether the market is capable of producing a substitute for the illicit file sharing networks which play such a prominent role in the music industry today.

### III. THE MARKET WILL NOT SUPPORT FILE SHARING TECHNOLOGY

In a normally functioning market, participants will develop and utilize new technologies to gain a competitive edge over their rivals. In the case of file sharing networks used to distribute MP3s, however, these technologies have been developed by individuals outside the music industry. Nineteen-year-old college student Shawn Fanning famously developed Napster,<sup>123</sup> and many of Napster's competitors have similar histories. Even when industry outsiders create emerging technologies, however, one might expect industry participants to co-opt the new technologies such as file sharing networks and use them to more effectively market their own products. This, however, has not been the case. As described above, the record industry has not only been unreceptive to file sharing technology, but has been hostile to it, seeking to shut down file sharing services and sue their users in order to suppress what it views as a threatening technology.<sup>124</sup>

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<sup>123</sup> Sixty Minutes, *The Brain Behind Napster*, Oct. 10, 2000, available at <http://www.cbsnews.com/stories/2000/10/10/6011/main239876.shtml> (last visited Apr. 11, 2006).

<sup>124</sup> Kristina Groennings, *Costs and Benefits of the Recording Industry's Litigation Against Individuals*, 20 BERKELEY TECH. L.J. 571, 571-72 (2005).

Given that the technology provides important benefits to consumers, is there a way to “save” file sharing networks? The best outcome would seem to be one in which consumers benefit from the convenience, low cost, and high variety of choices associated with file sharing networks, in which smaller, independent artists continue to enjoy broader access to the market, and in which all artists are compensated for their work. Instead, it appears as though digital distribution channels for music might be headed towards extinction, or may become solely a tool of illegal copyright infringement. This outcome is puzzling, because if file sharing networks actually generate value, then one would expect a properly functioning market to naturally arrive at an equilibrium in which file sharing or some equivalent technology exists and adds value to products. Some of the major labels have in fact made token efforts to support commercial file sharing networks,<sup>125</sup> but only half-heartedly. Rather, the industry seems intent on debilitating file sharing networks because of the serious threat they pose to the status quo. This section argues that the market is incapable of producing a suitable alternative to illicit file sharing networks for four reasons: 1) the “big five” labels, who control the market, have little incentive to develop the technology; 2) even if the labels did willingly develop the technology, they would have a difficult time competing with illicit networks because they could not match the catalogs currently available on those networks; 3) third party vendors would be unable to negotiate favorable

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<sup>125</sup> Robert MacMillan, *File-Sharing for Free*, June 29, 2005, <http://www.washingtonpost.com/wp-yn/content/article/2005/06/29/AR2005062900549.html> (last visited Apr. 9, 2006).



licensing terms and be profitable; and 4) if the labels coordinated favorable licensing rates with one another to assemble online catalogs that could match those provided by illegal file sharing networks, they would likely be doing so pursuant to cross-licensing agreements that would raise antitrust concerns. In short, the oligopolistic structure of the music industry dictates that it is incapable of creating a suitable alternative to the illegal file sharing networks so prevalent today.

**A. The Major Labels Have No Incentive to Promote File Sharing Technology**

The major labels who control the market have no incentive to promote legal file sharing communities. This is a difficult, and perhaps counter-intuitive, argument to make. After all, if services like Napster could amass such a devoted following, would it not be in the interests of the major labels to harness file sharing technologies in a profitable way? This section argues that the most profitable course of action for the major labels is to suppress online file sharing technology for two reasons.

*1. The Online Distribution of Music Erodes the Profitability of Compact Disc Sales*

First, the major labels will be unlikely to pursue file sharing technologies because the labels possess a comparative advantage in the distribution of physical compact discs and the value of this comparative advantage diminishes as the online distribution of music becomes more pervasive. The major labels make much of their profit by providing services associated with distribution, such as packaging,

marketing to retailers and shipping. These services are all rendered insignificant with the advent and prevalence of file sharing networks. The other major service provided by the labels is talent development and promotion, but file sharing networks allow artists to engage in self-promotion at virtually no cost. Hence, much of the value that the labels add to the music creation process is made obsolete by the proliferation of online music distribution systems.

2.      *The Suppression of Online Music Distribution  
Enables the Major Labels to Monopolize the  
Market for Music*

Second, the major labels can extract a greater profit by suppressing competition and ensuring that only their own artists are heavily promoted and available to the public. The labels attempt to achieve such a result by monopolizing radio air time and retail store shelf space. Online music distribution threatens these barriers to entry. File sharing is dangerous to the labels, because so long as music is only popularized through conventional media such as broadcast radio and retail shelf space, the labels are able to limit the diversity of music to which the public has access; but as soon as online music distribution becomes prevalent, independent artists can cheaply disseminate their music and subvert the control mechanisms employed by the major labels.

For both the reasons expressed above, the major labels have no incentive to develop file sharing technologies because the current regime of selling physical compact discs through retailers is currently their most profitable business model.

**B. Online MP3 Vendors Must Offer a Wide Library of Songs to Compete with Illegal File Sharing Networks**

The second reason that the market is unable to develop an appropriate alternative to the file sharing networks is that they cannot compete with the content available on the illegal networks.<sup>126</sup> While many individuals undoubtedly use peer-to-peer file sharing software to obtain music for free, many users also use these services for a number of other reasons, including the ability to access the greater variety of music available on these networks. As argued by Josh Bernoff, a researcher at Forrester Research, “[t]he reason people use free services is because they didn’t find what they were looking for – not that they didn’t want to pay.”<sup>127</sup> File sharing services offer a wide selection of music, reasonable pricing (free in the case of illegal downloads), and the ability to copy music files to any device without restraint (some commercial services restrict what users may do with the music they purchase).<sup>128</sup> Therefore, online vendors of music files are at a disadvantage not only because they are trying to generate a profit and are competing against a “free” product, but also because

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<sup>126</sup> Jim Hu, *Record Firms Learn Napster Lessons Slowly*, Aug. 2, 2002, <http://news.com.com/2100-1023-243985.html?legacy=cnet> (last visited Mar. 16, 2006).

Analysts say that until labels relax their control, there is little chance of creating a viable online marketplace for legitimate music, because music consumers do not care, or even know, about which labels distribute their favorite artists. Offering a service that lets people access songs only from one label's enormous library remains a limitation, not a liberation, they say.

*Id.*

<sup>127</sup> Laurianne McLaughlin, *Music Downloads: Is it Time to Pay?*, June 5, 2003, <http://www.pcworld.com/resource/article/0,aid,111040,00.asp> (last visited Mar. 16, 2006).

<sup>128</sup> *Id.*

they may not be capable of offering a product competitive in quality. One article describes how “KaZaA, the primary successor to Napster, is the most downloaded program in history.”<sup>129</sup> The more users a network such as KaZaA has, the more files are available to each user. The article describes how “during a recent week, users on KaZaA had 441 million files available to them, putting to shame the six hundred thousand files boasted by Napster at its height.”<sup>130</sup>

Though it may be extremely difficult to compete with illicit file sharing networks such as KaZaA, commercial services such as Apple’s iTunes have shown that it is in fact possible. Apple licenses songs from the five major labels and offers them to users at \$.99 each. Apple also sells complete albums at a discounted price, usually about \$10.<sup>131</sup> Apple’s policies are also not overly restrictive in that users are able to copy the songs to peripheral devices such as Apple’s own portable MP3 player, the iPod, and to blank compact discs that are playable on ordinary compact disc players. Given that Apple is selling a product that can otherwise be had for free, the success of its iTunes service is in some ways remarkable. In a single week soon after its inception, iTunes sold one million songs at \$.99 each.<sup>132</sup> What is impressive about this figure is that, at the time, iTunes only functioned on Apple’s Macintosh computers, which are owned by

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<sup>129</sup> Stacey Lantagne, *The Morality of Mp3s: The Failure of the Recording Industry’s Plan of Attack*, 18 HARV. J.L. & TECH. 269, 273 (2004).

<sup>130</sup> *Id.*

<sup>131</sup> McLaughlin, *supra* note 127.

<sup>132</sup> iTunes Music Store Sells Over One Million Songs in First Week, May 5, 2003, <http://www.apple.com/pr/library/2003/may/05musicstore.html> (last visited Mar. 16, 2006).

less than 1% of U.S. households.<sup>133</sup> There are a number of reasons why consumers may have been eager to legally purchase MP3 files, among them being morality (they did not want to steal), convenience (the illicit file sharing networks often carry corrupt or mislabeled files), and fear (RIAA lawsuits which personally sued individual file-sharers undoubtedly deterred some users from engaging in online file sharing).

Nonetheless, even the existence of iTunes, by far the most successful of the legal file sharing networks, hardly constitutes compelling evidence that the music industry is eager to embrace file sharing technology. Some reports even indicate that Apple actually loses money on each song sold through iTunes, and that the company views this loss as an acceptable marketing expense to promote its popular iPod portable music player.<sup>134</sup> Moreover, even if iTunes does exemplify a successful business model (which is probable, since competitors such as BuyMusic.com, MusicMatch/Dell, Napster, RealNetworks, and Microsoft have entered or are planning to enter the market to compete with Apple),<sup>135</sup> its sales are still a drop in the bucket compared to the traffic that occurs on the illegal file sharing networks. The NPD Group released a study of file sharing usage demonstrating that in the latter half of 2004, iTunes boasted roughly one million users a month while illegal peer-to-peer file sharing

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<sup>133</sup> Neil Strauss, *The New Season/Music: Rebounds, Repertory and Rascally Rhymes; Girls? Check. Cristal? Check. iPod? Check.*, N.Y. TIMES, Sept. 7, 2003, at § 2 Column 1.

<sup>134</sup> Paul Thurrott, *Microsoft Preps Online Music Store*, Nov. 18, 2003, <http://www.windowsitpro.com/Article/ArticleID/40886/40886.html> (last visited Mar. 16, 2006).

<sup>135</sup> *Id.*

networks received between 4.7 and 6.4 million users a month (with an upward trend).<sup>136</sup> Other studies show that as of June 2003, there were over 21 million people in the United States using peer-to-peer file sharing services, and that at any given moment an individual logging on to the KaZaA or Grokster networks had access to 3.4 billion unique MP3 files.<sup>137</sup> These figures indicate that Americans do seem willing and even eager to shift to legal vendors, but only if it makes sense to do so. Research group Ipsos-Insight reports that 47% of American people who download music had paid to download an MP3 file at some point as of December 2004.<sup>138</sup> This is twice as high as the 22% who had done so in December 2003, and five times as high as the number who had done so in December 2002.<sup>139</sup> To continue this upward trend in legal online MP3 sharing, however, online vendors must be able to offer a catalog comparable to that which is available on the illegal file sharing networks.

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<sup>136</sup> Press Release, NPD Group, *Apple iTunes Remains Dominant in Paid Digital Music Downloads*, Oct. 13, 2004, [http://www.npd.com/dynamic/releases/press\\_041013.html](http://www.npd.com/dynamic/releases/press_041013.html) (last visited Mar. 16, 2006).

<sup>137</sup> McLaughlin, *supra* note 127.

<sup>138</sup> Ipsos-Insight, *Popularity Of Fee-Based Music Downloading Takes Off*, Feb. 10, 2005, <http://www.ipsos-insight.com/industryfocus/cablemediaent/> (last visited May 5, 2005).

<sup>139</sup> *Id.*

**C. Third-Party Vendors Are Unlikely to Assemble a Competitive Library of Songs, or, Alternatively, Are Unlikely to Be Profitable**

*1. Third Party Vendors Will Not Have the Bargaining Power to Negotiate Favorable Terms with All Five Major Labels*

It would likely be impossible for online vendors to realistically offer a catalog comparable to those offered on illicit networks because doing so will either be unprofitable or invoke antitrust concerns. Online MP3 vendors can be divided into two categories: those that are operated by one of the “big five” distributors and those that are not. The latter category contains online stores such as Apple’s iTunes. The problem with these vendors is that in order to compete with the illegal online networks, they must be able to license music from each of the five major labels. Much of the appeal of file sharing services such as KaZaA is that they offer “one-stop-shopping” where all the files are available to a user through one central portal. In other words, if a vendor such as Apple is unable to come to licensing terms with even one of the five major labels, it is far less likely to appeal to consumers enough to draw them away from the illegal file sharing networks. This creates an anti-commons problem where any one of the five distributors can hold out and compel the online vendor to agree to unfavorable terms. Given the fact that each of the five labels has enough market power to be essential to iTunes’ success (after all, one can hardly imagine a successful record store that does not carry any albums distributed by one of the five major labels), they can likely extort a high licensing

fee from the vendor. While they may be unlikely to charge such a high price that it becomes unprofitable for the online vendor to stay in business, they can extract the majority of the profits from the vendor and create a disincentive to stay in business. Just as iTunes is beginning to exert an influence on the market and steal “customers” away from illicit file sharing networks, the major labels are considering licensing their songs to Apple at a higher price and driving up its costs. “Despite iTunes’ success and the growing success of other services, the record industry still isn’t happy; it thinks that 99 cents a song is too cheap, and the five major labels . . . are discussing a price hike ranging from \$1.25 to an eye-gouging \$2.49 per song.”<sup>140</sup> Even at its current price of 99 cents a song (of which roughly 65 cents is paid directly to the labels themselves as a licensing fee),<sup>141</sup> iTunes, which dominates 70% of the market for legal MP3 downloads,<sup>142</sup> is hardly a moneymaker. Phil Schiller, Apple’s Senior Vice President, notes that Apple’s portable music player, the iPod, is what “makes money . . . . The iTunes Music Store doesn’t. Just trying to have a business around downloadable music would be tough.”<sup>143</sup> Bill Gates, whose company Microsoft also intends to enter the business, agreed that “it’s maybe a feature your platform should offer, but it’s not like you’re going to make

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<sup>140</sup> Matt Buchanan, *Price Hike Will Sink iTunes*, Apr. 21, 2004, [http://www.nyunews.com/vnews/display.v/ART/2004/04/21/ARCHIVE71226?in\\_archive=1](http://www.nyunews.com/vnews/display.v/ART/2004/04/21/ARCHIVE71226?in_archive=1) (last visited Mar. 16, 2006).

<sup>141</sup> Anthony Maul, *Are the Major Labels Sandbagging Online Music? An Antitrust Analysis of Strategic Licensing Practices*, 7 N.Y.U. J. LEGIS. & PUB. POL’Y 365, 370 (2004).

<sup>142</sup> See *supra* note 136.

<sup>143</sup> Ina Fried, *Will iTunes Make Apple Shine?*, Oct. 16, 2003, [http://news.com.com/Will+iTunes+make+Apple+shine/2100-1041\\_3-5092559.html](http://news.com.com/Will+iTunes+make+Apple+shine/2100-1041_3-5092559.html) (last visited Mar. 16, 2006).



some (big) markup.”<sup>144</sup> Hence, even if a third party vendor such as Apple is able to negotiate licensing agreements with each of the major labels, it is unlikely to be able to do so at prices which enable it to operate a lucrative business.

## 2. *The False Promise of Collective Rights Organizing*

Robert Merges has persuasively argued that in many contexts in which vendors need to acquire a number of intellectual property licenses, collective rights organizations emerge which collectively represent the intellectual property rights holders and set group prices which effectively convert property rules into liability rules.<sup>145</sup> If a collective rights organization emerged in this setting, third party vendors would be able to sell the songs of any label belonging to the collective rights organization and pay the owner of the song or the label a predetermined license fee set by the collective rights organization.<sup>146</sup> This would allow the vendor to operate an online business without having to individually negotiate a price from each label holding the right to a song, and would also eliminate the holdout problem in which one particular label could refuse to negotiate reasonable terms in the hopes of extorting a high licensing fee. The existence of such a collective rights organization would reduce transaction costs and facilitate trading in much the same way

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<sup>144</sup> *Id.*

<sup>145</sup> See Robert P. Merges, *Contracting Into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 CAL. L. REV. 1293, 1293 (1996).

<sup>146</sup> Lionel S. Sobel, *Royalties from Abroad*, 23 ENT. L. REP. 10, (2002).

2006] *THE ANTI-COMPETITIVE MUSIC INDUSTRY* 439

as a compulsory licensing scheme would.<sup>147</sup> However, Merges' analysis only applies to those industries in which the property holder *wants* to sell its product. As this Article argued above, however, it is not in the interests of the major labels to promote file sharing services.<sup>148</sup> File sharing services erode the grip of the major labels on the industry and diminish the ability of the major labels to control what is offered to the public. As Moshe Adler, an economist at Columbia University has observed, in the music industry "money is made by reducing diversity."<sup>149</sup> Because it is not in the interests of the major labels to promote file sharing, it is unlikely that they will form any sort of collective rights organization that will alleviate the concerns a third-party online vendor would have with licensing songs from the major labels. Hence, the labels can use their market power to muscle out competitors or extract an unreasonably high licensing fee from any vendor who wants to sell its music.

### 3. *Game Theory and Keeping Out Competitors*

The conclusion that online vendors, independent of the five major labels, are unlikely to be successful because the labels will use their influence to drive up costs is supported by both theory and reality. Anthony Maul has, posited that

two of the peer-to-peer services sued by the industry, Napster and Kazaa, asserted antitrust counterclaims alleging that the five major labels ("Majors") engaged

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<sup>147</sup> See *infra* Part IV.

<sup>148</sup> See *supra* Part III.A.

<sup>149</sup> David Nelson, *Free The Music: Rethinking the Role of Copyright in an Age of Digital Distribution*, 78 S. CAL. L. REV. 559, 566 (2005).

in a concerted refusal to license their music to anyone other than MusicNet and Pressplay, the two Internet companies owned as joint ventures by the Majors themselves.”<sup>150</sup>

Moreover, the Department of Justice has conducted an inquiry into possible antitrust violations associated with the labels’ licensing schemes.<sup>151</sup> Maul concludes that while the labels probably did not explicitly collude to drive legitimate online vendors out of business, they did not need to do so.

[T]he Majors could achieve collusive results in the online market through the non-collusive exercise of their power in the licensing market. By delaying the creation of an online market, the Majors have ensured that prices in that emerging market will be high enough so that the profits enjoyed by the Majors from the sale of CDs are not undercut.<sup>152</sup>

Maul uses a game-theory analysis to show that, even in a five-firm market, the major labels are able to act collusively under tacit agreements not to grant favorable license terms to any third-party vendor.<sup>153</sup> In particular, the last of the five major labels to license their catalog to a particular vendor would be unlikely to do so on favorable terms.<sup>154</sup> Under this analysis, it is unlikely that any independent online vendor will be very successful. This is exemplified by the fact that Apple’s iTunes store is not profitable

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<sup>150</sup> Maul, *supra* note 141, at 366.

<sup>151</sup> *Id.*

<sup>152</sup> *Id.* at 367.

<sup>153</sup> *Id.* at 371.

<sup>154</sup> *Id.* at 374.

even though it dominates the market for legal MP3 downloads. Professor Roger Noll has argued that anticompetitive licensing practices on the part of the major labels will have the effect of squeezing out independent wholesale and retail competitors, thereby resulting in higher prices for consumers and fewer outlets for artists to distribute their recordings.<sup>155</sup>

#### **D. Online Ventures Run by the Major Labels Themselves Invoke Antitrust Concerns**

If online file sharing businesses run by independent vendors are unlikely to be profitable, what about file sharing businesses run by the big labels themselves? Two likely scenarios emerge from the prospect of file sharing services operated by the major labels. One possibility is that a service run by one label will have difficulty procuring the library of songs necessary to compete with the illegal file sharing networks. The second possibility is that if one of the labels does procure songs from each of the other major labels, it will be able to charge consumers a monopoly price and be guilty of antitrust violations due to collusive cross-licensing agreements.

With respect to the first scenario, any online enterprise run by one of the major distributors runs into the same problems as any service operated by an independent vendor regarding the catalog issue. To draw users away from illegal file sharing networks, a site run by one of the major labels would also have to sell songs distributed by the other four major labels. Here, the major labels

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<sup>155</sup> Peter J. Honigsberg, *The Evolution and Revolution of Napster*, 36 U.S.F. L. REV. 473, 483 (2002).

would once again run into the same problems regarding holdouts and the possibility that the major labels would not license their catalogs to one another at a reasonable price.

The only way for the major labels to escape this problem would be to license their catalogs to one another on mutually favorable terms. In other words, given that each of the five major labels wields significant market power and that the presence of each label's recordings are essential to a successful online venture, the only way for the labels to agree on a licensing scheme would be to cross-license their catalogs to one another on equitable terms. The likely upshot would be that each of the five major labels would license their music to one other at a roughly equivalent cost (one that may be much lower than the terms offered to third-party vendors) and the major labels would each offer their own websites that sell each other's songs at the same price.

Another possibility would be for the major labels to engage in a joint venture which launches one website that sells their combined catalog of songs. If they did so, they may be more likely to license their songs to third parties such as Apple's iTunes song at a higher price and drive those vendors out of business. This would leave the labels with a monopoly over the market for legal online MP3 transactions and also raise antitrust concerns.

In short, for the major labels to run their own online MP3 distribution sites would be problematic for one of two reasons. Individual labels operating their own sites with only their own songs would fail to compete with the illegal file sharing networks because

they would have a limited library of songs. In the alternative, if the labels jointly created a website, or cross-licensed their songs to one another on favorable terms, they would essentially be fixing prices because they collectively control the market for music.

When Napster was sued for copyright infringement, it alleged that the “big five” labels created two filing sharing networks, Pressplay and MusicNet, which essentially altered the market for music from one dominated by five firms to one dominated by two firms.<sup>156</sup> Judge Patel, who heard the Napster case, stated:

[t]he current record on the licensing practices of these joint ventures is negligible. However, even a naïf must realize that in forming and operating a joint venture, plaintiffs’ representatives must necessarily meet and discuss pricing and licensing, raising the specter of possible antitrust violations. These joint ventures bear the indicia of entities designed to allow the plaintiffs to use their copyrights and extensive market-power to dominate the market for digital music distribution . . . . Even on the undeveloped record before the court, these joint ventures look bad, sound bad and smell bad.<sup>157</sup>

Additionally, European authorities have also conducted an antitrust investigation into Pressplay and MusicNet.<sup>158</sup> This lends further credence to the claim that any coordination between the five major labels in the market for online music distribution – coordination that may be necessary to compete with illicit file sharing networks –

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<sup>156</sup> Fagin, *supra* note 3, at 467.

<sup>157</sup> *Id.* at 468.

<sup>158</sup> *Id.* at 454 n.3 (citing Veronica Garcia-Robles, European Union Considers Internet Music Services Pressplay and Musicnet, <http://www.europemedia.net/shownews.asp?ArticleID=6072> (last visited Oct. 15, 2001)).

raises antitrust concerns.

If this analysis is accurate, then the result of the Supreme Court holding that services such as Grokster are guilty of contributory infringement is that these services might be driven out of business. In this case, digital distribution technologies may not be used to disseminate music because the market seems incapable of producing an alternative to the current file sharing networks. One might nonetheless envision an outcome in which artists voluntarily choose not to enforce their copyrights and place their songs in legal file sharing networks to build up their reputations and promote their careers. Unfortunately, it is improbable that such networks would succeed because users would be unlikely to sample the music of artists with whom they are entirely unfamiliar. The illegal file sharing networks successfully increase awareness of unknown artists because these artists are found in companion with more established artists who the file-sharers may actually be searching for. For example, a user might go online seeking to download a particular song receiving heavy radio airplay. At the time the user is downloading the song from an anonymous user, he may look at that other user's library of songs and realize that they share similar musical tastes. The user then samples some of the other user's songs and happens to stumble across several new artists he likes. Anecdotally speaking, this is how new artists are generally discovered through a file sharing network. Users are unlikely to randomly download an artist they have never heard of without some impetus to do so. Hence, a legal file sharing network containing only

unestablished artists is unlikely to draw interest. Rather, the networks must possess songs promoted by the major labels via radio airplay to attract users. Given the current legal regime and the fact that the market is dominated by the “big five” labels, it is unlikely that legal file sharing networks will emerge and gain significant popularity unless they carry songs offered by the five major labels – which, as we have seen, may not occur because of antitrust concerns.

#### **IV. THE ARGUMENT FOR COMPULSORY LICENSING**

The argument up to this point can be summed up as follows: 1) the public is best served by policies that encourage the optimal amount of creative innovation in the production of music; 2) the public is also served by Internet technologies, such as peer-to-peer file sharing services, which allow for the cheap, online dissemination of music; 3) the vast majority of artists, who are unrepresented by one of the five major labels, also benefit from such services which allow them to cheaply publicize their work; 4) even some well-established artists working with one of the five major labels benefit from online distribution technologies through an increase in recognition and fame; 5) the major labels which control the market suffer from the existence of legal and illegal file sharing technologies because these technologies replace much of the value that the labels add to the music promotion process and diminish the labels’ control of the market; 6) because the major labels suffer from the existence of file sharing technology, and because they exert control over the market, they are likely to pursue policies that maintain the preexisting status quo and minimize the impact of new Internet technologies for



distributing music; and 7) in the absence of some shock to the market or government intervention, the outcome will be the suppression of online distribution technologies and a diminution in the social good.

### A. Possible Solutions

If the suppression of online distribution technologies and a diminution in the social good is the likely outcome given the industry's current structure and the government's current policies, then what role can the government play in remedying this situation and creating an environment in which the socially optimal amount of music is produced?

#### 1. *The Contenders*

There are a number of possible solutions the government might pursue. One solution would be to break up the five major labels in order to create a market in which there are too many competitors to allow a few dominant players to engage in tacitly collusive behavior. However, it would be basically impossible to justify breaking up the five major record labels absent stronger evidence of monopolistic behavior. Another possibility might be to create an exception in the copyright law for non-commercial file sharing. This is the path Canadian courts have taken,<sup>159</sup> and, if the reasoning in Part II is correct, would lead to the optimal amount of creative activity. This is arguably the most sensible position, but it is a solution that is unlikely to be successful in the United States due to

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<sup>159</sup> John Borland, *Judge: File Sharing Legal in Canada*, Mar. 31, 2004,

legal precedent, the fact that the RIAA is a powerful lobbyist in American politics, and perhaps most importantly due to the normative belief fervently held by many Americans that artists ought to be compensated for their work. William Fisher has argued somewhat persuasively for a system in which artists would be compensated through a federally administered reward system funded by tax dollars.<sup>160</sup> However, such a solution would raise a number of concerns. Among other problems, Fisher's proposal would completely alter the way in which we understand the role of artists in society and revamp our understanding of property rights in art; it would create an elaborate government bureaucracy responsible for administering the system; and it would require the taxing of individuals for artwork they may deem offensive. This Article settles on a less drastic solution that is likely to alleviate many of the concerns that exist with the current status quo without prompting the concerns raised by the other proposals: a scheme of compulsory licensing.

## 2. *The Compulsory Licensing Solution*

A system of compulsory licensing for online music distribution would convert an artist's or label's interest in musical recordings from the type of right governed by property rules to the type of right governed by liability rules. In other words, in today's world, Record Company A can authorize any other vendor, such as

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[http://news.com.com/2100-1027\\_3-5182641.html](http://news.com.com/2100-1027_3-5182641.html) (last visited Mar. 16, 2006).

<sup>160</sup> FISHER, *supra* note 2 (providing a summary of the federally administered reward system).

Apple's iTunes store, to sell its copyrighted song at any price it is able to negotiate – or, alternatively, to entirely prevent iTunes from selling its songs at all. A liability rule, in contrast, would allow any qualified vendor to sell the songs of Record Company A pursuant to some predetermined arrangement, such as a fixed licensing fee set by a regulatory agency.

A compulsory licensing scheme would be an effective solution to the problems facing online music distribution technologies for several reasons. One reason is that the music industry is very similar to other industries which are subject to government regulation and systems of compulsory licensing. Another reason is flexibility; a compulsory licensing regime could be broad enough to allow for the development of different distribution technologies, and could also be flexible enough to allow different vendors and artists to develop distinct business models for the online distribution of their songs. Additionally, compulsory licensing in the online distribution of songs would not be a radical departure from the status quo because, as the following sections will demonstrate, compulsory licensing already exists in other segments of the music industry.<sup>161</sup> In fact, a proposal has already been introduced in Congress that shares key elements with this Article's proposed compulsory licensing scheme.<sup>162</sup> Finally, this section will identify and address three prominent arguments against compulsory licensing.

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<sup>161</sup> Mark B. Radefeld, *The Medium is the Message: Copyright Law Confronts the Information Age* in *New York Times v. Tasini*, 36 AKRON L. REV. 545, 583 n.206 (2003).

<sup>162</sup> Statement of Marybeth Peters, The Register of Copyrights before the Subcommittee on Courts, the Internet, and Intellectual Property, Committee on the Judiciary, June 21, 2005, <http://www.copyright.gov/docs/regstat062105.html> (last visited Mar. 21, 2006).

**B. How Compulsory Licensing Would Work and the Benefits of Such a System**

How exactly would a system of compulsory licensing work? There are a number of potential models, and this section will sketch out one vision of how such a regime might be implemented. Additionally, this section will illuminate the benefits such a system would bring about: namely, the promotion of independent music unaffiliated with the major labels, the flexibility to accommodate different business plans, the increased likelihood that artists will be compensated for their labor and the preservation and development of online music distribution technologies.

*1. The Formation of a Regulatory Agency*

The first step in developing a system of compulsory licensing would be the formation of a regulatory agency responsible for administering the program. This agency could perhaps be affiliated with the Copyright Office, and would collect licensing fees from third-party vendors which it would then distribute to the registered copyright holders whose songs are being licensed. Online vendors would also be required to register with the agency and would have to demonstrate that they meet certain baseline requirements in order to have the right to distribute songs copyrighted by others. Some of these requirements may include: 1) that the vendor has an adequate business plan and sufficient capital to ensure that the vendor will stay in business and make its licensing payments; 2) that the vendor takes security precautions to prevent the theft of the songs being licensed and to safeguard the credit card and privacy information of its

customers; and, 3) more controversially, that the vendor agrees to carry a certain percentage of songs performed by independent artists who are not represented by any of the five major labels.

## 2. *The Independent Artist Requirement*

The requirement that online vendors carry a certain percentage of music developed by independent artists relates back to the argument in Part II of this Article that online distribution networks encourage innovation by breaking down barriers to entry and giving the public exposure to new artists. One might wonder why, if there is public demand for music produced by independent artists, Congress would need to statutorily mandate that online vendors carry a certain percentage of independent artists. After all, one would expect online music vendors to naturally offer selections created by independent artists if it is profitable to do so. However, this presumes a competitive market. In fact, the market suffers from an information asymmetry because the major labels control the public's access to new music. Consumers may be unable to signal their demand for independently created music because they are simply unfamiliar with the music being created by the 98% of musicians who are unaffiliated with one of the five major labels. Accordingly, vendors may be unsure of what songs to carry. By requiring online vendors to carry a catalog of songs that is comprised of at least 20% independent artists, Congress will ensure that some independent artists' songs are made available to consumers and that the public is able to easily learn about new artists through means other than the conventional channels of distribution such as

2006]      *THE ANTI-COMPETITIVE MUSIC INDUSTRY*      451

commercial radio and MTV (which are controlled by the major labels). Moreover, this imposition is a reasonable one – much more reasonable than say, requiring a record store to devote 20% of its shelf space to independent artists, since the online storage and distribution of songs is considerably cheaper. Such a system will ensure that the public still enjoys the benefits associated with online music distribution and that independent artists continue to escape the stranglehold the major labels have on the music industry.

### 3.      *Flexible Pricing Increases the Likelihood That Artists Will Be Paid*

Another benefit of the compulsory licensing system compared to the illicit file sharing networks dominant today is that it would increase the chances that artists will be compensated for their work. As iTunes demonstrates, it is possible to create a robust online music distribution business so long as the major labels do not charge third party vendors an exorbitantly high price. In terms of logistics, vendors would simply pay the agency a fixed fee for each song sold online, which would then be remitted to the artist or their label.

What about the actual licensing fee? The regulatory agency ought to set price ranges for different bundles of products to ensure that vendors can employ different marketing strategies and business models. Since online file sharing is an emerging technology and no one can predict precisely how it will develop, the ability to be flexible and accommodate different marketing ideas is a particularly important and attractive feature of the compulsory licensing plan. Artists registering a copyright could set prices for different products

within predetermined guidelines set by the agency. For example, songs can be sold online in a variety of different ways that are not possible in the conventional record store model. Vendors may sell each song for a different price depending upon its “duration.” For example, files can be valid for a particular number of listens (the song can be encoded with a digital watermark such that after it is listened to ten times it automatically deletes itself), files can be valid for a particular amount of time (after one month the song deletes itself) and files can be unrestricted (the user may listen to the song unlimited times and transfer the songs to portable music devices and blank compact discs as many times as he or she chooses). For each type of transaction that the agency permits (and the agency can permit as many different models as the market would naturally produce), it can set a range of prices. For example, the agency could set guidelines directing that a song which can be listened to an unlimited number of times but cannot be copied must be licensed to third-party vendors at any price set by the copyright holder ranging from nothing to \$1.50. The agency’s goal in setting these pricing guidelines would be two-fold: 1) to set a wide enough range of prices so that artists can sell their work at a price roughly equivalent to that which would be established in a competitive market (bearing in mind that the current market operates as an oligopoly and does not function as a competitive market would); and 2) to set a maximum price which is low enough that the five major labels cannot simply price online vendors out of the market and force consumers back into record stores for a lack of alternatives.

#### 4.      *Non-Discriminatory Licensing*

The agency also ought to mandate that whatever licensing terms are offered to one online vendor must be offered to all other vendors. This non-discriminatory licensing policy will prevent collusive pricing schemes where, for example, the five major labels offer each other favorable terms and price third-party vendors out of business by charging them an exorbitant licensing fee.

#### 5.      *Compulsory Licensing Will Save File Sharing and Other Forms of Legal Online Music Distribution*

Another important benefit of the compulsory licensing system would be the preservation of online distribution technologies. The survival of these technologies is uncertain in the current marketplace and under the current legal regime. The continued existence of widespread online music distribution guarantees important benefits to the public, including convenience, lower costs, and access to more creative content.

#### 6.      *Summary*

The discussion above demonstrates that compulsory licensing provides numerous benefits to both artists and the American public. Perhaps the most important aspect of the compulsory licensing proposal is that it would give independent artists the ability to reach more consumers. As described in Part I, the record industry possesses tremendous control of the market through policies such as pay-for-play on the radio and cooperative advertising programs that



monopolize retail store shelf space. The compulsory licensing scheme would alleviate the harm perpetrated by these programs by requiring online vendors to guarantee that a certain percentage of their catalogs consist of independent artists. Further, it allows for flexible pricing policies so that these artists can sell their music for free or at a low price should they choose to do so. Less established artists might, for example, distribute songs which are free for ten listens and must then be paid for. Such a system would be flexible enough to accommodate various business models and pricing plans and would enable independent artists to better promote their music.

One concern may be that such a scheme would be too complicated to administer. But with all transactions being digitally recorded, it would be easy to monitor how many times each song is purchased under each of the various pricing schemes, as well as the license fee associated with that particular transaction. If the agency plays the role of arbiter in any licensing fee disputes, it could also levy penalties that would fund its own existence. For example, a vendor which fails to pay the required license fee to a copyright holder would be liable for the unpaid license fee in addition to a monetary penalty.

This compulsory licensing proposal would preserve online distribution technologies, giving consumers the ease, convenience and lower costs associated with online services as well as greater access to creative content generated by independent artists.

**C. Compulsory Licensing Is an Appropriate Response to Current Market Conditions**

A few questions arise after considering how the aforementioned scheme for compulsory licensing might operate. Is the scheme appropriate? Is it overly intrusive into the market? Does it erode the rights of copyright holders too much? The answer to these questions is no. The market for music possesses the characteristics generally present in a regulated industry. Moreover, compulsory licensing in the context of online song distribution is hardly a radical proposal given other examples of compulsory licensing in the market for music.

*1. The Music Industry Is the Type of Market for Which Regulation Is Appropriate*

Markets that are ripe for government intervention are those in which the market, for any number of reasons, does not function as it should. As Part I demonstrated, the music industry in the United States is dominated by five firms who are able to exert influence over the market and are able to shut out competitors. Their dominance is underscored in the market for the digital distribution of music because any online vendor needs access to the catalogs of all five major labels in order to effectively compete with the illicit file sharing networks. The general conditions under which governments implement compulsory licensing schemes have been described as follows:

where (a) new distribution media or technologies are introduced, (b) transaction costs are very high owing to the large number of licensors, and (c) where

potential licensees need to obtain licenses from most or all of them to be effective. Compulsory licensing is also a preferred option when dominant players threaten to exercise market power anti-competitively.<sup>163</sup>

Clearly, each of these conditions applies to the market for online music distribution. The Internet and file sharing technologies are new developments; it would be prohibitively expensive to license songs from each of the major labels and from the 98% of artists who are unrepresented by one of the major labels; any online vendor needs licenses from each of the five major labels and probably from some of the unrepresented artists in order to be successful and compete with illicit file sharing networks; and the music industry is one in which the dominant players have exercised their market power anti-competitively. The market for the online distribution of songs is precisely the type of market in which government invention and the implementation of a compulsory licensing scheme are appropriate.

## 2. *Compulsory Licensing in the Music Industry: Other Contexts*

A compulsory licensing scheme would not be groundbreaking. Musicians are able to “cover,” or create their own rendition of any artist’s songs, so long as they pay a set fee of eight cents for each copy made.<sup>164</sup> Public broadcasting stations can also play any artist’s songs during a non-commercial broadcast for a predetermined fee. Similarly, jukebox owners can play any artist’s

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<sup>163</sup> Fagin, *supra* note 3, at 523.

<sup>164</sup> FISHER, *supra* note 2, at 144-45.

songs as long as they pay a governmentally determined licensing fee. These three examples demonstrate that compulsory licensing is not a revolutionary idea in the music industry. In particular, compulsory licensing has already been utilized in the online distribution of songs by webcasters.<sup>165</sup> In other words, webcasters, or operators of websites who make noninteractive broadcasts of copyrighted sound recordings over the Internet (also known as “streaming” downloads which the Internet user hears but cannot copy), can do so without the copyright holder’s permission as long as they pay a license fee of seven cents for every listener who hears a song.<sup>166</sup> The government implemented these webcasting regulations for precisely the same reasons that this Article argues for compulsory licensing in the context of online MP3 sales. Fisher describes how

an expert witness testifying for the record companies argued that, if the companies were able to set Webcasting license fees without interference from the government, it would be rational for them deliberately to select levels high enough to force approximately two thirds of the existing Webcasters out of business in the near future. By pruning the weaker firms in this way, the record companies would make the Webcasting industry as a whole more profitable – and would make it easier for them in the end to buy up the survivors.<sup>167</sup>

This anti-competitive impulse is present in each of the “big five” record companies and has a major impact on all aspects of the market for online music distribution.

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<sup>165</sup> Karen Fessler, *Webcasting Royalty Rates*, 18 BERKELEY TECH. L.J. 399, 399 (2003).

<sup>166</sup> *Id.* at 408-09.

<sup>167</sup> FISHER, *supra* note 2, at 160-61.

### 3. *The Music Online Competition Act*

The idea that online digital sales of music should be subject to licensing regulations was also the impetus behind the Music Online Competition Act ("MOCA"), proposed by Congressmen Chris Cannon and Robert Boucher in 2001.<sup>168</sup> The proposed act had two main components. The first major component was that online vendors of music would be required to make royalty payments directly to artists or to an organization collectively representing the artists. The artists or the organization would then make royalty payments to the record companies responsible for distributing their music.<sup>169</sup> By taking the funds out of the control of the record labels, this portion of MOCA aimed to ensure that artists were paid for their work. While this is a reasonable piece of legislation, it is not a necessary part of the proposed compulsory licensing scheme and may be seen as an unnecessary imposition on the market.

The second important component of MOCA is a provision stating that labels could not engage in discriminatory licensing; in other words, every third-party vendor to whom songs were licensed had to receive the same terms.<sup>170</sup> Congressman Boucher contends that "[i]f the major record companies do not also license independent unaffiliated distribution services, this could create a competitive

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<sup>168</sup> Introductory Statement of Representative Chris Cannon H.R. 2724, the "Music Online Competition Act" (MOCA), Aug. 2, 2001, <http://www.house.gov/cannon/press2001/aug03.htm> (last visited Mar. 21, 2006).

<sup>169</sup> Patrick J. Gorman, *The Proposed Music Online Competition Act: One Step Forward or One Step Back?*, [http://www.piercegorman.com/music\\_online\\_competition.html](http://www.piercegorman.com/music_online_competition.html) (last visited Mar. 16, 2006).

<sup>170</sup> Congressman Rick Boucher, Summary of Music Online Competition Act, <http://www.house.gov/boucher/docs/moca-summary.htm> (last visited Mar. 16, 2006).

imbalance that could threaten the establishment and survival of independent online music services.”<sup>171</sup> This idea is an important first step in ensuring that the five major labels are not able to exert their market power to grant each other favorable licensing terms and drive competitors out of business. But the provision does not go far enough because the labels could simply choose to set extremely high licensing rates for everybody. This would be consistent with the proposed rule because the labels would not be setting discriminatory rates. Yet they could still be setting rates high enough to make online music distribution unprofitable. This would allow the major labels to continue deriving excess profits from compact disc sales while suppressing digital file sharing technologies.

Congress never passed the MOCA and it does not appear as though there are any plans to reintroduce it.<sup>172</sup> Nonetheless, the fact that MOCA has already been proposed, coupled with the fact that compulsory licensing exists in other facets of the music industry, underscores that the proposed compulsory licensing scheme does not go far beyond current marketplace regulations which are seen as striking an appropriate balance between the rights of copyright holders, third-party vendors and the public.

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<sup>171</sup> *Id.*

<sup>172</sup> See *Intellectual Property: Conyers Says Time Not Ripe for E-Music; Distribution Bill*, NAT'L J. TECH. DAILY, January 8, 2002 (“[T]he time is not ripe for Congress to pass legislation designed to speed the fair distribution of music content on the Web.”).

#### **D. Challenges to Compulsory Licensing and Responses**

In addition to the benefits associated with a compulsory licensing scheme, there are also several important drawbacks that must be considered. These include: institutional incompetence, the possibility of regulatory capture and the fact that the compulsory licensing program in and of itself does not prevent the continued use of illicit file sharing networks. This section will argue that while each of these problems are serious drawbacks in principle, they are still improvements upon the status quo.

##### *1. Institutional Incompetence and Why it Does Not Matter*

##### *a. Problems in Price-Setting and Price-Adjusting*

What this Article refers to as institutional incompetence broadly encompasses two problems Robert Merges has identified with compulsory licensing: the problem of setting initial prices and the problem of adjusting prices.<sup>173</sup> According to Merges, converting property rules to liability rules (as a compulsory licensing scheme does) works only when the property being sold or licensed can be fairly valued.<sup>174</sup> Compulsory licensing involves a fixed legislative valuation that applies to all “property” regardless of its individualized value. In addition to the problem of initially pricing the value of the

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<sup>173</sup> Merges, *supra* note 145, at 1307-16.

<sup>174</sup> *Id.* at 1303.

property being licensed, compulsory licensing suffers from a stagnation problem in that it may be difficult to change prices.<sup>175</sup>

b. The Current Market Structure Already Distorts Prices

While *Merges* is correct to point out these flaws in compulsory license regimes, they are mostly inapplicable to the compulsory licensing scheme proposed here. *Merges*' first complaint, that the prices are unlikely to be set at the efficient level, would carry more weight if not for the fact that the current market structure already leads to distorted price levels.<sup>176</sup> As Part I demonstrated, the major labels have already been found guilty of artificially inflating compact disc prices through anticompetitive practices. Part I also described how the major labels use exorbitant marketing funds to crowd out newcomers and monopolize the market. These practices shut out competition, and since consumers are mostly unaware of the 98% of music being produced by artists unaffiliated with the major labels, the labels are able to suppress supply and extract artificially high prices from consumers. The anticompetitive practices of the major labels are particularly price-distorting because they not only function to limit the supply of music available to consumers, but the marketing funds the labels use to suppress the competition are then passed on to consumers in the form of higher prices. Hence, compared to the status quo, the

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<sup>175</sup> *Id.* at 1308. Under *Merges*' view, "a statute is hard to change and hard to get rid of . . . this well-recognized feature of legislation is sufficient by itself to cast doubt on virtually all compulsory licenses." *Id.*

<sup>176</sup> *Id.* at 1307.



administrative agency's inability to set the efficient price is not particularly relevant.

c. Price Ranges Address Merges'  
Concerns About Inflexible Pricing

More importantly, the compulsory licensing proposal outlined in this Article is particularly immune to these complaints because it does not set a fixed price for the product being sold but rather sets a price *range*. This feature is important in several respects. Merges' general complaint is that legislative valuation is unable to set individualized prices for different pieces of property that have different values.<sup>177</sup> However, the intellectual property rights holders licensing their property under this proposal have the ability to self-determine the value of their property within the predefined price guidelines. Because the regulatory agency has the flexibility to set a wide range of prices, it is likely to set price ranges that include the efficient prices for most or even all property holders. The fact that a range of prices is available to property holders also addresses Merges' concern that the legislature does not adapt its statutorily determined prices quickly enough to accommodate changing conditions.<sup>178</sup> Because prices are set by the entities licensing their own property, they are likely to be cognizant of the changing value of their product and can adjust prices accordingly. For example, a music group that licenses its product at one dollar per song and achieves immense fame has the ability to set a higher price on its next

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<sup>177</sup> *Id.* at 1308.

<sup>178</sup> Merges, *supra* note 145, at 1308.

album. Since property holders have a range of prices available to them, any lag the agency has in adjusting the applicable price ranges is not nearly as problematic as the lag in a typical compulsory licensing system in which all property holders are constricted to a fixed price, which may not be adjusted quickly enough to match changing market conditions. So long as the agency does not set a price range so wide as to facilitate anti-competitive behavior,<sup>179</sup> it has discretion to set a range of prices that can accommodate the reasonable value of any song being licensed. Accordingly, the legislature's and agency's institutional incompetence with regards to price-setting is not troublesome because the agency would set price ranges instead of fixed prices, and can set these ranges wide enough to alleviate Merges' concerns.

## 2. *The Problem of Regulatory Capture*

The second criticism against the system of compulsory licensing is that the agency and legislature are vulnerable to regulatory capture.<sup>180</sup> Under public choice theory, this is precisely the type of environment in which regulatory capture is most likely to

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<sup>179</sup> For example, allowing the major labels to license their songs out at \$10 each may lead each of the major labels to do so. The upshot would be to shut out third party online vendors, as well as online distribution sites run by the labels themselves since the compulsory licensing proposal outlined here mandates non-discriminatory licensing fees. This, however, would be to the advantage of the major labels because it would maintain the status quo in which the primary means of selling music is through the sale of physical compact discs. This, of course, is the area in which the major labels hold a competitive advantage and in which they can derive the greatest profits. For further analysis of this point, see *supra* Section III.A.

<sup>180</sup> See [http://en.wikipedia.org/wiki/Regulatory\\_capture](http://en.wikipedia.org/wiki/Regulatory_capture) (last visited Mar. 23, 2006). "Regulatory capture is a phenomenon in which a government regulatory agency becomes dominated by the interests that it oversees." *Id.*

occur.<sup>181</sup> The group most likely to benefit from compulsory licensing is the American public, which is widely dispersed, whereas those that are most likely to suffer, the “big five” record labels, are well-organized, well-funded and share a common interest in rent-seeking. While this is certainly a severe problem when compared to an ideally functioning market, it is no worse than the status quo. Assuming the compulsory licensing program was implemented, the labels’ best course of action would be to lobby for a high limit to the predetermined price guidelines and to lower the percentage of independent artists the online vendors would be required to carry. Nevertheless, any online distribution site run by one of the major labels or by any third party vendor would be required to carry a certain percentage of songs created by independent artists. These artists would maintain the flexibility to sell their music at the low end of the price range, or even for free. This would break the grip of the major labels on the market for music, and, in the long run, allow for a more competitive marketplace. In short, while the agency administering the compulsory licensing system would potentially be

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<sup>181</sup> Frank I. Michelman, *Political Markets and Community Self-Determination: Competing Judicial Models of Local Government Legitimacy*, 53 IND. L.J. 145, 148-49 (1977).

In the economic or public choice model, all substantive values or ends are regarded as strictly private and subjective. The legislature is conceived as a market-like arena in which votes instead of money are the medium of exchange. The rule of majority rule arises strictly in the guise of a technical device for prudently controlling the transaction costs of individualistic exchanges. Legislative intercourse is not public-spirited but self-interested. Legislators do not deliberate towards goals, they dicker towards terms. There is no right answer, there are only struck bargains. There is no public or general social interest, there are only concentrations of particular interests or private preferences.

*Id.*

vulnerable to some degree of regulatory capture, the resulting market for music would still be superior to the present one in which the major labels use their power to successfully shut out competition.

### 3. *The Problem of Illegal File Sharing*

The third major criticism of the compulsory licensing program proposed in this Article is that it does not solve the problem of illicit file sharing. Although this is true, a compulsory licensing regime is nevertheless a vast improvement compared to the status quo. The industry's current position of dealing with illegal file sharing by pursuing draconian lawsuits against its own customers is hardly working. As Internet access spreads around the world, the United States legal system will be even less capable of dealing with illegal file sharing because files will increasingly be downloaded from offshore locations which escape the jurisdiction of American courts. Felix Oberholzer-Gee has described the industry's current approach to illicit file sharing as "hopeless":

[T]he RIAA's legal strategy [of suing its customers] is hopeless and smacks of short-sighted panic. Our research shows that only 45 percent of music files downloaded in the United States come from computers in the U.S. More than 100 countries supply files to the U.S. file-sharing [sic] community, and many of these countries do not have strong records of protecting copyrighted materials. The RIAA does not stand a chance to implement an effective legal strategy in all these countries. Those who dream of legal solutions do not recognize the truly global nature of the peer-to-peer (P2P) phenomenon. Even worse, the RIAA's legal strategy does not even seem to work here in the United States. Despite the lawsuits – the

RIAA has sued about 2,000 individuals to date – file sharing is more popular than ever.<sup>182</sup>

If it is true that illegal file sharing is likely to grow unchecked without a radical change in the way music is distributed, then compulsory licensing's inability to eradicate illegal file sharing is hardly a valid criticism. If anything, compulsory licensing is likely to lessen the extent of illegal file sharing because it will conveniently make high-quality audio files available to consumers at a reasonable price. As the discussion of Apple's iTunes Music Store in Part III revealed, consumers are willing to legally purchase music online when they feel as though they can find the music they want at a reasonable price. In addition, an increase in the number of people legally purchasing their music will, over time, probably shift cultural norms away from the understanding that illegal file sharing is acceptable.<sup>183</sup> Hence, while a system of compulsory licensing will not eradicate the threat of illicit file sharing, it will alleviate the problem, especially compared with the status quo.

## CONCLUSION

The market for music is a market in flux. The file sharing revolution has upended the traditional means of selling and distributing music and, at least for the record industry, has opened a Pandora's Box of illegal file sharing. While independent artists have

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<sup>182</sup> Silverthorne, *supra* note 88.

<sup>183</sup> See, e.g., Strahilevitz, *supra* note 60, at 535 n.114. "According to a Pew poll taken shortly before the Napster decision, sixty-four percent of those between the ages of eighteen and twenty-nine believe that there is nothing wrong with downloading music for free off the

enjoyed newfound access to the public, the major labels have watched in dismay as their grip on the industry has loosened. Meanwhile, while consumers have been thrilled with the ease, convenience and diversity offered by online file sharing, they have also engaged in widespread theft and have, in some cases, been the subject of punitive lawsuits. The Internet and file sharing revolutions have, as new technologies often do, shaken things up.

It is in these times of flux that we are most apt to reevaluate the current state of affairs and the way things could be. Compulsory licensing offers a way to balance many of the interests at stake in this debate: it eliminates the major labels' control over the industry while also increasing the likelihood that their product is not pilfered; it allows artists to sell their music directly to consumers in new ways and especially allows independent artists to reach an audience which was previously blocked off to them, creating incentives to innovate; and most importantly, it allows consumers to legally enjoy the myriad benefits of file sharing technology, which include increased access to new and diverse artistic content. David Boies, the attorney representing Napster, aptly articulated the appropriateness of compulsory licensing in the context of online music distribution:

The purpose of the copyright laws is to provide a fair incentive for creative activity, not to allow the use of copyrights to extend an oligopoly's control of one market to a new technology. A compulsory license at a fair rate could both provide fair compensation to the copyright holder and permit consumers to benefit from

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Internet." *Id.* (internal citations omitted).

the advantages of new technology.<sup>184</sup>

For these reasons, a scheme of compulsory licensing in the market for online music distribution would serve the public interest by promoting a new technology that benefits consumers while respecting the rights of artists and promoting creative activity.

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<sup>184</sup> See Mirapaul, *supra* note 91.

**APPENDIX I: INDEX OF FIVE MAJOR LABELS<sup>185</sup>****Universal Music Group****• Major Artists**

U2	Marilyn Manson
Erykah Bahdu	Moody Blues
Beck	Nine Inch Nails
Blink 182	No Doubt
Peter Gabriel	Sting
Jimi Hendrix	Stevie Wonder
Jonny Lang	Rob Zombie
Limp Bizkit	98 Degrees

**• Major Labels**

Interscope/Geffen	Mercury Nashville
Island Records	Motown Records
Def Jam	Verve Music
MCA Records	Universal Records

**Sony Music Entertainment****• Major Artists**

Aerosmith	Fuel
Fiona Apple	Macy Gray
Louis Armstrong	Lauryn Hill
Ben Folds Five	Michael Jackson
Mariah Carey	Yo-Yo Ma
Cypress Hill	Pearl Jam
Miles Davis	Carlos Santana
Dixie Chicks	Soul Asylum

**• Major Labels**

Columbia	Legacy Recordings
Epic	Sony Nashville
Sony Classical	

<sup>185</sup> The Big Five, <http://musicians.about.com/library/big5/blbig5.htm> (last visited Apr. 9, 2006).



## EMI Group

### ● Major Artists

Medeski, Martin & Wood

Beastie Boys

The Beatles

Foo Fighters

Pink Floyd

Radiohead

Ben Harper

Janet Jackson

Lenny Kravitz

Fatboy Slim

D'Angelo

The Rolling Stones

Sex Pistols

John Lee Hooker

### ● Major Labels

Angel Records

Blue Note Records

Capitol Records

EMI Classics

Grand Royal Records

Virgin Records

## Warner Brothers Music

### ● Major Artists

Tori Amos

The Corrs

Hootie & The Blowfish

Jewel

Kid Rock

Led Zeppelin

Rod Stewart

Stone Temple Pilots

Metallica

Phish

The Cure

Green Day

Barenaked Ladies

Eric Clapton

### ● Major Labels

Atlantic Records

Elektra Records

Reprise Records

Warner Brothers JazzSpace

Warner Brothers Records

Warner Classics

## **BMG Entertainment**

### ● **Major Artists**

Dido

Dave Matthews Band

Outkast

Toni Braxton

Christina Aguilera

Whitney Houston

Sarah McLachlan

Pink

O-Town

Run-DMC

Brooks & Dunn

Alabama

Diamond Rio

### ● **Major Labels**

Arista Records

RCA Label Group

BMG Classics

**APPENDIX II: CD SALES: WHERE THE MONEY GOES<sup>186</sup>**

The following is a breakdown of where the money goes when we buy a CD. Typically, the artist earns just over \$1 on every CD sold. Promotion, video, recording and touring costs are often subtracted from that figure, leaving the artist with very little after every one else has been paid.

<b>Royalty Math</b>		
Consider this hypothetical example based on realistic figures. Suppose a new band signs a contract stipulating a royalty rate of 14%, which applies to cassette sales. The CD rate is 85% of that. The band records its first album on a \$300,000 budget with a producer who gets a standard 3% royalty share.		
<b>CD suggested retail price</b>		\$18.98
<b>Less packaging (25%)</b>	-	\$4.74
<b>Royalty base</b>	=	\$14.24
<b>Royalty rate</b> 14% minus 3% for the product, multiplied by .85 to determine CD rate	=	9.35%
<b>Royalty rate per CD</b>	=	\$1.33
<b>Royalty amount x 500,000 CDs</b>	-	\$665,000
<b>Less 15% free goods</b> (Copies given away to retailers, distributors, radio stations and reviewers)	-	\$99,750
<b>Less recording costs</b>	-	\$300,000
<b>Less 50% of independent promotion</b> (Cost of hiring outside agents to secure radio airplay. Multi-format campaigns can run \$350,000 to \$700,000 per single)	-	\$100,000
<b>Less 50% of video costs</b>	-	\$75,000
<b>Less tour support</b> (Losses accrued on tour. Few new acts break even on the road)	-	\$50,000

<sup>186</sup> Canadian Internet Policy and Public Interest Clinic, *File-Sharing*, <http://www.cippic.ca/en/faqs-resources/file-sharing/> (last visited Apr. 9, 2006).